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Resource Revanchism:
The Privatization and Renationalization
of the Russian Oil Industry

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of the Russian Oil Industry

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Thesis

Presented to the Faculty of the Graduate School of

The University of Texas at Austin

in Partial Fulfillment

of the Requirements

for the Degrees of

Master of Global Policy Studies

and

Master of Arts

The University of Texas at Austin

May 2016

Acknowledgements

I would like to thank my thesis committee, Dr. David Spence, Dr. Fred Beach, and Dr. Catherine Weaver, for their guidance and willingness to work with me on this project. Additionally, I would like to acknowledge the professors here at The University of Texas at Austin that have helped me grow academically and professionally over the last three years.

Abstract

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by

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The University of Texas at Austin, 2016

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The Russian oil industry has long been one of the most prominent and valuable oil sectors in the world. Under the Soviet Union, the oil industry was subject to tight state control. Prices and production targets were determined by political leaders in Moscow, not market signals. The 1995 industry privatization after the collapse of the Soviet Union resulted in many industry assets being auction at extremely discounted prices to a few connected businessmen. Some of the new oil company owners quickly invited Western companies to partner in Russian plays. The differences in Western business culture, oilfield operations, and profit-seeking behavior created tremendous resentment among the rank-in-file Soviet-era oilmen. They, along with conservatives, believed their skepticism of Western involvement was vindicated by a devastating Russian recession in the late 1990s. This economic crisis paved the way for Vladimir Putin's election in 2000. A former intelligence officer with a desire to reassert Russian influence on the global stage, Putin quickly sought to recapture state control of the oil sector. By the end of his first term in 2004, Putin had orchestrated the fall of the most prominent oligarch, Mikhail Khodorkovsky, and his oil company Yukos, funneling its most valuable assets into a new

state oil champion, Rosneft. The path of the Russian oil industry from fully state-owned enterprises to private companies and back to falling under heavy state influence underscores the importance of oil as a resource to the Russian state and, most importantly, how the long history of strong, autocratic governance in Russia affected its relationship with foreigners, served as the impetus for renationalization in the 2000s, and continues to influence the Kremlin's view that Russia's energy industry is, first and foremost, a tool of the state.

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Introduction

Following the collapse of the Soviet Union, leaders of the new Russian Federation set out to remake the economic structure in their country by establishing a market-based system open to the rest of the world. The privatization of state assets that followed fundamentally shifted the balance of financial and political power in the country. One of the most prized industries to leave state control was the tremendously valuable and strategically important oil sector. While most industries maintained relative independence, freedom from the state was short-lived in others. Perhaps most notably, the nascent private oil companies in Russia quickly found their assets in the Kremlin's crosshairs.

In diplomatic parlance, *revanchism* is the term for a policy pursued by a state seeking to reclaim land lost in war. In losing and subsequently clawing back ownership of its oil resources, Russia's treatment of its natural resource sector exhibited shocking parallels to a state targeting its lost territory. Less than a decade after initiating a privatization process, Russian leadership began using the tools of the state to influence the ability of the oil industry to make independent business decisions. Over time, those in power solidified their view that control of the oil sector was critical to Russia's national interest, resulting in ever more state involvement. By the mid-2000s, the Kremlin wielded so much influence that the state was the de-facto owner of the largest oil company in the country. Today, in the culmination of a policy of resource revanchism, the most valuable and strategically important oilfields and related industry assets are either officially or effectively under state control.

Why were Russian oil assets brought back under state influence so shortly after being sold? The answer lies in the details of the disintegration of the Soviet system; the asset privatization process; a series of cultural clashes pitting Soviet-era oil bosses and conservative Russia leaders against the young, liberal oligarchs and their Western business partners; and, ultimately, the belief by those in the Kremlin's upper echelons that Russian grand strategy necessitated centralized control of the oil industry.

Two Themes

In analyzing the arc of the Russian oil sector over its first fifteen post-communist years, two themes appear in stark relief: the critical importance that oil plays in the Russian economy and the extent to which Russian culture and history impact the development of the industry. Throughout this study, these two trends will be readily apparent, regularly acting as drivers of both private industry and public sector decision-making. Perhaps most importantly, given the prominence of these two themes in recent Russian history, they offer a valuable lens through which to analyze current Russian leadership and potential future decisions coming from the Kremlin.

Recent supply-side discussions and market analyses regarding the global oil market often revolve around Saudi Arabia and the United States. As the leader of the Organization of Petroleum Exporting Countries (OPEC) and the vanguard of the shale revolution, respectively, this focus is not at all surprising. However, Russia quietly ranked third in 2014 in production of petroleum and other hydrocarbon liquids, behind only Saudi Arabia and the United States, pumping 10.9 million barrels per day (b/d).[1] The United States Energy Information Administration (EIA) reported in July 2015 that Russia was the world's largest producer of crude oil (including lease condensate).[2] This is not a new phenomenon. Russia has long been known for its oil wealth, with some of the first major oil operations in the world located in Baku, what was then Russian territory but is now the capital of Azerbaijan.[3] As the industry grew, so too did its importance to the state. In 2010, oil accounted for 28% of total government revenue according to the Natural Resource Governance Institute[4] and 14.7% of total Gross Domestic Product (GDP) according to the World Bank.[5]

Russia's reliance on oil as a percentage of export revenue is even greater. In 2013, crude oil and petroleum products accounted for 33% and 21% of total export revenue,

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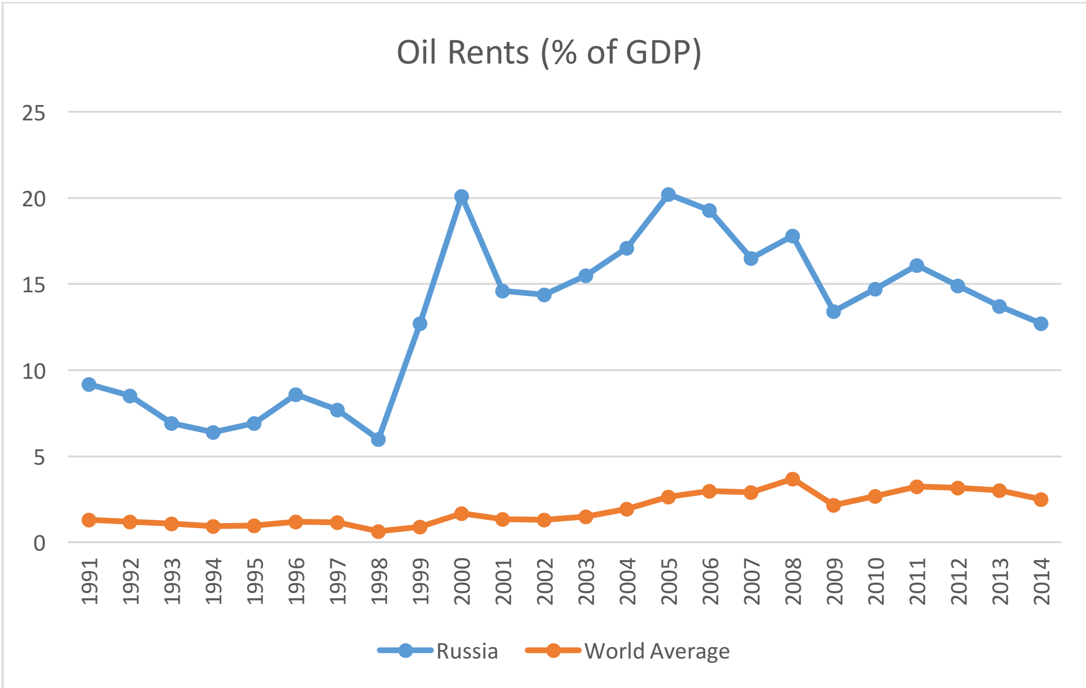
[1] "Russia." The United States Energy Information Administration. July 28, 2015. https://www.eia.gov/beta/international/analysis_includes/countries_long/Russia/russia.pdf.
[2] "Russia." The United States Energy Information Administration. July 28, 2015. https://www.eia.gov/beta/international/analysis_includes/countries_long/Russia/russia.pdf.
[3] Yergin, Daniel. *The Prize: The Epic Quest for Oil, Money, and Power*. New York: Simon & Schuster, 1991. 57-61.
[4] "Russia." Natural Resource Governance Institute. http://www.resourcegovernance.org/countries/europe/russia/overview.
[5] "Oil Rents." The World Bank. 2011. http://data.worldbank.org/indicator/NY.GDP.PETR.RT.ZS/countries/1W-RU?display=graph.

Figure 1: Oil Rents as a Percentage of GDP: Russia Versus World Average



Source: World Bank, 2011. http://data.worldbank.org/indicator/NY.GDP.PETR.RT.ZS?page=4

respectively, totaling 54% of over $523 billion (USD).[6] Revenue generated via exports is a pertinent figure because it demonstrates the role that the oil industry plays in the ability of the Russian economy to acquire foreign currency reserves. A steady flow of global reserve currencies such as the US dollar and the euro is important, as these currencies help insulate Russia from fluctuations in the value of its own currency, the ruble. Oil revenue and the strength of the oil industry is, by no small measure, an extremely important component of the Russian economy and the state's ability to maintain fiscal

[6] "Oil and natural gas sales accounted for 68% of Russia's total export revenue in 2013." The United States Energy Information Administration. July 23, 2014. https://www.eia.gov/todayinenergy/detail.cfm?id=17231.

strength. Sitting with the world's eighth-largest bounty of proved reserves,[7] approximately 80 billion barrels,[8] the oil industry is unlikely to lose this position of prominence in Russia any time soon.

The second theme that pervaded the development of the Russian oil sector throughout the 1990s and early 2000s was the influence of the country's unique history and culture. Three aspects within this theme stick out in particular: Russia's history of authoritarian governance, the Kremlin's deep-seeded suspicion of foreign influence, and the desire to recover from the embarrassment resulting from the collapse of the Soviet system. These historical and cultural undercurrents served as ever-present factors that shaped the relationship between the oil industry and the Russian government.

The history of strong central government in Russia dates back to the beginning of the Tsarist era in 1524 and lasted until the end of the Soviet era in 1991. Authoritarian rule had notable effects on the oil industry. Overall, it influenced the ability of Soviet-era oilfield managers to adjust to structural changes to the economy that were instituted in the 1990s. In the 2000s, the tradition of strong central government remained important, as it also helped color the way that Vladimir Putin and his political allies viewed the relationship between the oil industry and the state.

The legacy of strong central government looms large in the Russian ethos. Russian Tsars ruled for centuries via divine right. Their authority was absolute.[9] In this

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[7] "Crude Oil Proved Reserves – 2015." The United States Energy Information Administration. https://www.eia.gov/beta/international/.
[8] "Worldwide Look at Reserves and Production." *Oil and Gas Journal*, December 1, 2014, 32.
[9] Engelstein, Laura. "Combined Underdevelopment: Discipline and the Law in Imperial and Soviet Russia." *The American Historical Review* 98, no. 2 (1993): 338. doi:10.2307/2166836.

regard, the Tsars were similar to the other monarchs of 15^{th}-18^{th} century Europe. However, this sense of national pride and exceptionalism developed differently in Russia than in the other great European monarchies such as Great Britain and France. Throughout its history, perhaps as a result of its expansive size and ungovernable borderlands, Russia has regularly had to defend itself from foreign invaders. This history of invasion attempts allowed the Tsar to entreat his subjects to coalesce in defense of the homeland and build a sense of nationalistic pride that buffeted the legitimacy of his authority.[10]

When Napoleon's Grande Armée spread throughout Europe, sowing the seeds of weakness in the concept of absolute rule, Tsar Alexander I of Russia perceived an existential threat not only to Russian territorial integrity, but to the very system of government that legitimized his regime.[11] As such, not only did he employ his forces to stifle Napoleon's invasion of Russia, Tsar Alexander I created the Holy Alliance with the Austrian Empire and the Kingdom of Prussia in order to suppress liberalism and other revolutionary movements in Europe.[12]

When such revolution broke out across the continent, the eastern monarchies of the Holy Alliance, with Russia as its leader, proposed a plan to the Concert of Powers to approach the "problem" as they would regular crime. In this *Protocole*, the Tsar proposed "preventing the progress of the evil with which the body social is menaced."[13] In this

[10] Notable invasions of Russia include the Mongols in 1223 and 1236, Sweden in 1707, and France in 1812.
[11] Bobbitt, Philip. *The Shield of Achilles: War, Peace, and the Course of History*. New York: Alfred A Knopf, 2002. 157.
[12] Bobbitt, Philip. *The Shield of Achilles*. 165.
[13] Bobbitt, Philip. *The Shield of Achilles*. 166-167.

regard, Russia served as the guarantor of the divine right of kings, the philosophical underpinning of absolute rule. It is little surprise that Russia was the last remaining absolute monarchy in Europe, with that form of government remaining until the Bolshevik Revolution in 1917.

While the divine right of the Tsars ended with the fall of the Romanov dynasty in 1917, authoritarianism, strong central government, and duty to the state certainly did not. Soviet leadership, while presuming to speak for and enable the masses, kept a commanding grip on state decision-making, maintaining fierce control over the central planning of the economy.[14] The oil industry was no exception. This was clear throughout the 1990s and early 2000s. This dynamic between the oil sector and the state proved to be a great source of tension between the free market champions that saw profit as their North Star and the government officials that could not fathom resource companies not serving state interests. In this sense, Russia's lack of experience, so to speak, with democracy and separation between the state and the private sector had a tremendous influence on the experience of the Russian oil industry in the wake of the Soviet collapse.

[14] For examples of the centralized control of the Soviet revolutionaries and ruthlessness of their security services in buttressing the state and communist ideology, see *The Sword and the Shield: The Mitrokhin Archive and the Secret History of the KGB* by Christopher Andrew and Vasili Mitrokhin. Mitrokhin was a career archivist at the KGB who, for decades, stashed documentation of Soviet security operations classified at the highest level. *The Sword and the Shield* offers an unparalleled look into the extent that the Soviet Union maintained the tsarist tradition of absolute centralized control.
Andrew, Christopher M., and Vasili Mitrokhin. *The Sword and the Shield: The Mitrokhin Archive and the Secret History of the KGB*. New York: Basic Books, 1999.

Chapter I: Going Vertical: The Soviet System Falls Apart

The Soviet Oil Apparatus

The structure of the Soviet oil sector was very hierarchal. Policymakers in the Kremlin made high-level industry decisions and delegated oversight of everyday operations to various ministries. Located in Moscow, the Ministry of Oil managed decisions regarding upstream activities such as the production and transportation of crude oil. Refining and other midstream processes were governed by a separate entity, the Ministry of Refining and Petrochemicals. Finally, a third government office, the Ministry of Foreign Trade, oversaw the management of oil exports. At each point in this chain of control, the title of the product changed hands, leaving each individual entity, most consequentially for the Ministry of Oil, very little control beyond its ministry-specific purview. In this regard, the Soviet oil industry structure was very disjointed and flat, far from vertically integrated and internally communicative like Western international oil companies (IOCs). A mid-level Soviet oil worker responsible for production could spend his entire career without ever having the need to speak with someone in charge of refining or other operations further downstream.[15]

Due to tight government control and strict adherence to the 5-year production plans issued by the Kremlin, nobody that actually managed the product at any point in the value chain was responsible for making decisions of consequence. Instead, top ministry officials and more senior policymakers in the Kremlin set production targets that were to be strictly followed. The person in charge of imposing Moscow's production targets was often the political boss of the province in which a given oilfield was located. This boss, technically the first secretary of the party's province committee, was known as the *obkom*.

The *obkom* issued Kremlin directives to the regional production associations, the *ob"edineniia*, which in turn controlled oilfield-level production units known as *neftegazodobyyvaiushchaia upravleniia*, or NGDUs. There were two divergent opinions of Moscow's production strategy held by Soviet oil workers in the trenches: first, that production should be pushed higher, and second, that the ever-increasing production targets recklessly led to premature oilfield decline. However, their opinions mattered little. Failing to meet the goals dictated by Moscow was an invitation for disaster for the *obkom* and, by extension, to miss targets passed along by the *obkom* was career suicide

[15] Hewitt, Ed A. *Energy, Economics, and Foreign Policy in the Soviet Union*. Washington, DC: Brookings Institution, 1984.

for the oilmen. In the early 1980s, hundreds of senior managers were fired due to their failure to meet higher production targets.[16]

Such production targets were not governed by economics or market dynamics. In fact, the centrally planned economy of the Soviet Union hardly functioned as an economy at all. It was more of a mechanism for turning oil into a source of solvent funding for various political priorities. This manner of resource development was a recipe for disaster for the long-term sustainability of the sector. Soviet oilmen were often trained as geologists and engineers in the country's various technical universities. As such, while they were aware of some of the physical and geological repercussions of excessive production, they did not grasp the complex financial management that an executive at any IOC would undoubtedly understand. In the Soviet oil workforce from the policymakers down to the oilfield bosses, collectively referred to as *neftianiki*, nobody worried much about cost management or optimizing return on investment.

In this sense, the Soviet era oil industry benefited from what economist János Kornai refers to as "soft budget constraints." Kornai says that the relationship between earnings and expenditures in certain economic units or industries can be 'relaxed,' particularly in socialist systems. Under this concept, a state that occupies a more paternalistic role toward certain industries or firms can offer support that allows the firms to pursue activities that they otherwise would not if they had to adhere strictly to the constraints of their revenue stream. This government support can include lobbying, tax

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[16] Gustafson, Thane. *Wheel of Fortune: The Battle for Oil and Power in* Russia. Cambridge, Massachusetts: The Belknap Press of Harvard University Press. 2012. 33-34

breaks, and cash subsidies among other forms.[17] A firm or industry that receives state support and benefits from soft budget constraints has less incentive to focus clearly on increasing efficiency and maximizing profit.

In the Soviet world of soft budget constraints and politically mandated production targets, funding was wasted and misallocated on poor projects. Wells were drilled in inefficient formations. Reservoir pressure was not managed, contributing to the precipitous and inordinate decline of production rates. Permanent cities with large non-oil worker populations were constructed around prominent oilfields, leaving the government eager to prevent any "bust" periods in the typical boom-bust cycle from ever setting in.[18] In short, the top-down policies from the Kremlin completely skewed the incentive structure of the Soviet oil sector.

Gorbachev's Perestroika

Mikhail Gorbachev came to power vowing to reboot the struggling Soviet economy. Shortly after becoming President of the Soviet Union in 1985, Gorbachev initiated his signature program, *perestroika*. This initiative, which would last through the twilight of the Soviet Union in the early 1990s, sought to introduce small market incentives into the command economy in order to retain the essence of the Soviet system while allowing it to react with a bit more agility to global market signals and the needs of industry. As Gorbachev would find, the introduction of market forces was tantamount to

[17] Kornai, János, Eric Maskin, and Gérard Roland. "Understanding the Soft Budget Constraint." *Journal of Economic Literature* 41 (2003).
[18] Gustafson, Thane. *Wheel of Fortune: The Battle for Oil and Power in Russia*. Cambridge, Massachusetts: Belknap Press of Harvard University, 2012. 35.

opening Pandora's box, and despite the good intentions behind his program, *perestroika* was the beginning of the end for Soviet control of the economy all together.

A fundamental underpinning of the Soviet system was that administrators in Moscow set prices. When Gorbachev allowed prices to be determined by supply and demand, the artificial equilibrium held in place by the Kremlin quickly readjusted. This caused the value of the ruble to drop and invited inflation, crippling what were previously stable government revenue streams.[19] Another dramatic aspect of *perestroika* was the shift in control over finances, investments, and, perhaps most importantly, hiring decisions from central state control to the regional enterprise managers. Naturally, the authority of local managers to hire and fire employees also meant that oil workers could quit their jobs to take positions for other operations under different bosses. The Kremlin underestimated the scarcity of labor in the oil industry, resulting in a chaotic shift in power from the central government not to the local bosses, but to the workers. The common rig operators began to make wage demands and hold elections for their bosses. This change undermined the very basis of Soviet authority over labor. Gorbachev tried to reverse some of the changes in order to manage the transition, but it was too late.

Throughout the *perestroika* era, from 1985 to 1991, the central government tried desperately to maintain high production levels in the oil industry in order to keep state revenue stable. Warm weather in 1986 helped to increase crop yields and lower demand for heating oil, which increased revenue that the state could use to invest in the oil industry and mitigate the drop in global oil prices. In subsequent years, as agricultural

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[19] Aslund, Anders. *Gorbachev's Struggle for Economic Reform*. Ithaca, NY: Cornell University Press. 1991

output returned to average levels, the Kremlin was forced to rely on its foreign currency reserves to prop up the industry.[20] From 1985 to 1989, central government funding for capital expenditure in the oil industry rose by 47%.[21] Of course, this strategy was not sustainable, and as foreign currency reserves declined, so too did the production levels of Soviet oilfields.

The oilfield managers pleaded with the central government to cut production quotas and allow greater quantities of oil to be exported so that they could raise the capital required to purchase much-needed equipment. Policymakers in Moscow were determined to maintain high production levels in order to keep government revenue steady and prevent producers from shortchanging domestic supply in order to sell greater quantities of oil in the more lucrative export market. Increased exports, they feared, would cause a supply shortage in the domestic market.[22] While *perestroika* restructured the economy in a way that Gorbachev saw as necessary to institute and manage *incremental* change in the USSR, the changes only sped up as the Soviet system reached its twilight.

Yeltsin's 'Shock Therapy'

Boris Yeltsin was elected President of the Soviet Union in June 1991, at a time when many doubted the ability of the Soviet system of governance to survive the dramatic changes instituted under Gorbachev. Indeed, by the end of 1991, the Soviet

[20] Gaidar, Yegor. *Collapse of an Empire: Lessons for Modern Russia*. Brookings Institution Press: Washington, DC, 2010. 133.
[21] Sagers, Matthew J. "News Notes: Special Regional Development Program for Tyumen' Oblast' Established by RSFSR Government," *Soviet Geography* 32, no. 9 (1991): 633.
[22] Aslund, Anders. *Gorbachev's Struggle for Economic Reform*. Ithaca, NY: Cornell University Press. 1991

Union ceased to exist. President Yeltsin was not blind to the writing on the wall. Instead of suffering through the death throes of the command economy, Yeltsin and his advisors opted to suddenly force even greater structural changes in the hopes that economic recovery would come more quickly. This 'shock therapy,' as the West called it, stemmed from the idea that the only way to avoid a prolonged period of economic distress was to, as author Chrystia Freeland puts it in her 2000 book *Sale of the Century*, "first demolish the Communist structure and then erect a market economy on the cleared site." This effort consisted of immediate decontrol of prices, large cuts in government spending, and a quick privatization of state assets.[23]

Despite the sweeping nature of these changes, the oil industry was again singled out by the state as a sector of strategic importance. In order to keep fuel prices in the domestic market from rising too quickly, Moscow exempted oil from deregulation, keeping prices artificially low. However, for most sectors, the broad price deregulation caused the cost of goods to rise quickly. This put the oil industry in a bind, as profits were capped below the true market equilibrium despite the cost of inputs (i.e., equipment and maintenance) being more expensive.[24] This dynamic sent oilfield managers scrambling to secure the limited permits to export oil, which allowed them access to the more profitable global market.

The hunt for export permits exposed a critical component of the privatization process that remains important today: the state-run monopoly over transportation

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[23] Freeland, Chrystia. *Sale of the Century: Russia's Wild Ride from Communism to Capitalism*. New York, N.Y: Crown Business, 2000. 34.
[24] Shleifer, Andrei and Daniel Treisman. "The Struggle to Beat Inflation." Chap. 3 in *Without a Map: Political Tactics and Economic Reform in Russia*. Cambridge, MA: MIT Press, 2000.

infrastructure and exports, centralized under an entity called Transneft. As previously noted, selling oil abroad during Yeltsin's 'shock therapy' was considerably more lucrative than selling in the regulated domestic market, creating a high demand for export permits. The Kremlin saw its control of Transneft as important leverage over the oil companies. However, Moscow was unable to effectively use Transneft for this purpose in the early 1990s.

This was the case for two reasons: first, in the relative vacuum left by the collapse of the Soviet Union, exports were difficult to track and quotas were often broken; product was sold abroad without the proper approvals. Second, Transneft, despite being managed and funded by the government, was in a poor financial situation. The reason for this is that, throughout the 1980s and into the 1990s, Transneft operated by taking ownership of the oil passing through its physical infrastructure rather than simply being paid a fee for its services. This system worked when the Soviet government set prices and ensured that Transneft received fair compensation. However, when government control relaxed, upstream companies charged higher prices in order to recoup production costs while downstream customers only paid Transneft market prices for the product, resulting in significant financial losses in the midstream.[25]

In 1991, Valerii Cherniaev, the longtime head of Transneft, rectified the unsustainable pricing arrangement. Cherniaev invited foreign consultants to help design a tariff system similar to the ones employed by electric utilities in the West. In the new system, Transneft stopped taking ownership of the oil, but instead charged a fee for its

[25] Gustafson, Thane. *Wheel of Fortune: The Battle for Oil and Power in Russia*. Cambridge, Massachusetts: Belknap Press of Harvard University, 2012. 80-83.

services. This system shielded Transneft from oil price fluctuations and guaranteed a steady source of income, which it used to repair aging infrastructure. With Transneft remaining a state-owned enterprise that did not take title of the product passing through its infrastructure, the nature of competition in the industry shifted further downstream, putting greater pressure on refineries and export terminals.[26]

Centrifugal Forces Reined In

From the late 1980s through 1992, the period after the start of *perestroika* but before the privatization process began in earnest, the Russian oil industry was marked by two phases of asset management: a rapid decentralization of assets and then a reconsolidation of assets into a handful of holding companies. As previously noted, *perestroika* delegated much of the decision-making power traditionally held by the central government to the local oilfield managers. This decentralization of authority acted as a centrifugal force in the oil industry that broke the institutional bonds that tied various oilfields together. Not surprisingly, the regional bosses and oilfield managers sought to cement control over their operations, resulting in an industry littered with a vast number of disparate production enterprises.[27]

The industry was transforming from a horizontal, compartmentalized bureaucracy into a vertically integrated structure. However, with each oil boss attempting to assert authority over his small piece of the pie, this industry structure was unacceptable to many of the top managers and policymakers. The operating environment was chaotic. In an

[26] Gustafson, Thane. *Wheel of Fortune*. 86
[27] Gustafson, Thane. *Wheel of Fortune*. 92

industry that relies heavily on technical cooperation for production and financial cooperation for exploration, the only way to allow numerous small companies to successfully operate, as in the United States, is to have a strong institutionalized rule of law. This was simply not the case in early-1990s Russia.[28]

University of Wisconsin Professor of Law and Political Science Kathryn Hendley characterizes the Russian legal environment as a dual system, one of 'rule of law' and 'telephone law.' When civil suits are brought between parties of similar social status, the 'rule of law' persists. However, in cases that involve parties with ties, formal or informal, to the government, 'telephone law' becomes more common. Hendley describes 'telephone law' as the "practice by which the outcomes of cases allegedly come from orders issued order the phone by those with political power rather than the through the application of law."[29] As the oil industry in Russia fragmented into a multitude of small entities, many of which having extensive ties to high-ranking government officials, the increased threat of 'telephone law' hurt the business environment and stifled cooperation between the small oil-producing entities.

One player in the industry pioneered an innovative organizational method meant to bring order to the chaos. Vagit Alekperov, the recently appointed deputy minister of oil, saw the negative effects of the industry Balkanization and suggested the creation of holding companies comprised of various production enterprises. The primary purpose of such entities was to stall the disarray in the industry and incentivize the coordination

[28] Gustafson, Thane. *Wheel of Fortune*. 75
[29] Hendley, Kathryn. "Telephone Law and The Rule of Law: The Russian Case." *Hague Journal on the Rule of Law* 1 (2009): 241-262.

characteristic of vertically integrated companies. In this arrangement, the *ob"edineniia* (regional operations) maintained *legal* autonomy from the state, but did fall under temporary *management* of the holding companies.[30]

In 1992, Boris Yeltsin created four such holding companies. Despite initial pushback from the *ob"edineniia* bosses, most ultimately concluded that this was the best opportunity to preserve their stakes. The owners of the consolidated assets received interest in the company in return for relinquishing decision-making authority to the new parent company. By taking a 45% stake in each company, the Kremlin both ensured that the state benefited from oil sales and proved to the investors that it was committed to their success. The agreement stipulated that the holding companies would dissolve after three years, giving the state sufficient time to develop a privatization process.

The first three companies – LUKoil, Yukos, and Surgutneftgaz – were made up of enterprises that voluntarily entered the arrangement. The remaining *ob"edineniia* either could not find a place within one of the first three holding companies or objected to the plan all together. The *ob"edineniia* that composed this group were not centered in a specific region, but rather scattered all over Russia, making the prospect of organizing them into a successfully operating enterprise virtually prohibitive. Nonetheless, the Kremlin ordered the conglomeration of assets grouped into a fourth holding company, a hodge-podge to be temporarily controlled by the state. Since the random group of assets

[30] Hedlund, Stefan. *Putin's Energy Agenda: The Contradictions of Russia's Resource Wealth*. Boulder: Lynne Rienner, 2014. 99-100

had little in common other than being located in Russia, the holding company was given the simple name "Russian oil," otherwise known as "Rosneft."[31]

By establishing the temporary holding company arrangement, Moscow halted the centrifugal forces at play in the oil industry. By the mid-1990s, the introduction of vertical integration helped stabilize production levels, while the gradual liberalization of prices and export quotas engendered enough confidence in the industry that investment started to return. However, the three-year holding company mandate ended in 1995. The subsequent process of privatization and introduction of foreign partners greatly shaped the development of the industry and its relationship with the state for the next decade.

[31] Goldman, Marshall I. *Petrostate: Putin, Power, and the New Russia*. Oxford: Oxford University Press, 2010. 61-62

Chapter II: Sale of the Century

When Boris Yeltsin consolidated the oil sector into four temporary holding companies in 1992, he set in motion a three-year scramble to consolidate control of the industry's assets. The players involved desperately wanted to be well-positioned in 1995 when the holding company assets would be auctioned off. With only a couple of notable exceptions, the overarching theme of this three-year period was that the *neftianiki* lost control of the oil assets to the young financiers that comprised the emerging oligarch class. For the purpose of this study, the emerging group of oil industry oligarchs are defined as the liberal, market-minded, financially-savvy reformers outside of government that successfully navigated the industry privatization process in order to gain ownership of Russia's oil assets.

The financiers executed an impressive takeover of the industry. They targeted ownership of the profitable oil export permits, leveraged their position in the export market to expand their control into the midstream and upstream sectors, and used the secondary market to buy up publicly-issued vouchers for the 1995 auction. For added insurance, some young oligarchs made timely loans to the debt-ridden Kremlin in order to curry government favor heading into the auctions. Yukos is perhaps the clearest example of how the financiers took over Russia's oil assets. Conversely, LUKoil serves as the primary exception to this trend. Its *neftianiki* leaders pushed to consolidate control through vertical integration and thus successfully fended off the oligarch vultures.

This privatization process was marred by corruption and the influence of the emerging class of oligarchs. While two companies, LUKoil and Surgutneftgaz, stayed under the control of Soviet-era oilmen, they were the aforementioned exceptions to the rule. By and large, the old guard of oilfield managers, the *neftianiki*, lost ownership of the assets they labored to maintain during the centrifugal stage of the early 1990s and the holding company stage from 1992 to 1995. This represents a critical pivot point in the path of Russian oil industry, most importantly because the market-minded reformers that replaced the *neftianiki* at the helm of the newly privatized industry precipitated a significant break from the state.

The oligarchs asserted control and independence from state influence and desires. They hired and fired employees, developed assets according to their own plans, and incorporated foreign capital and expertise. Perhaps most egregiously, some of the oligarchs sought to take advantage of the immature new tax structure by using loopholes and accounting tricks to minimize their tax liabilities. These tactics were known as "tax optimization" methods and they sat precariously on the line between legal and illegal activity.[32] The process by which the Russian oil industry was privatized set the stage for its relationship with the Kremlin for years to come.

<u>*Vultures begin to circle*</u>

The oligarchs started positioning themselves to take control of oil assets well before the official privatization process began. As previously noted, changes in Transneft's business model forced the center of gravity in industry competition from upstream production managers further downstream to refiners and exporters. Several factors incentivized the *ob"edineniia* under the management of the regional oil bosses to seek to sell their product abroad rather than domestically. For example, the price disparity between the two markets created a lucrative arbitrage opportunity for the *ob"edineniia* managers. Additionally, Russia's economic woes caused oil consumption at home to drop, leaving a supply glut in the domestic market that applied additional downward pressure on prices. The market environment left the *neftianiki* scrambling to obtain export permits.

The Foreign Trade Organization, the *Soiuznefteeksport*, was housed under the Soviet Ministry of Foreign Trade. While the *Soiuznefteeksport* never officially ceded the authority to manage exports, it lost much of its capacity in the disarray of government reorganization and effectively lost its capability to oversee and maintain this process.[33] In the absence of an orderly export-control system, the Yeltsin government designated

[32] Gustafson, Thane. *Wheel of Fortune: The Battle for Oil and Power in Russia*. Cambridge, Massachusetts: Belknap Press of Harvard University, 2012. 103
[33] Sagers, Matthew. "News Notes: Russian Crude Oil Exports in 1992: Who Exported Russian Oil?" *Post-Soviet Geography* 34, no. 3 (March 1993): 208

favored oil traders known as *spetsy* to be in charge of purchasing oil on behalf of the state, managing export permits, and selling the oil on global markets. The proto-version of the oligarch class saw the opportunity to gain influence over one of the most lucrative parts of the industry and thus began to establish ties to the *spetsy*.

Relationships between the oilfield bosses that controlled the upstream sector and the nascent oligarchs that wielded significant influence over the downstream sector varied from company to company. Some executives, notably those managing LUKoil and Surgutneftgaz, proactively embraced vertical integration, did not become over-leveraged, and successfully established footholds in the chaotic downstream sector.[34] Their strong financial situation and clear corporate control helped them fend off the oligarchs' influence.

However, many of the *neftianiki* failed to establish the same level of vertical integration and maintain sound finances during the 1992-1995 holding company period. Thus, with the *spetsy* and oligarch class controlling 93% of the crude oil exported by Russia,[35] the shift in industry power from upstream to downstream necessitated a similar shift in power from the *neftianiki* to the oligarchs. By 1994, the balance of power within these companies tilted in favor of the financiers, positioning them well to finish their takeover by wresting ownership during the official privatization process.[36]

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[34] As an aside that highlights the murky nature of the downstream business in the early 1990s, Russian organized crime syndicates seeking to establish a foothold in the oil business regularly murdered those involved in the export sector.
Bower, Tom. *Oil: Money, Politics, and Power in the 21st Century*. New York: Grand Central Pub., 2009. 127

[35] Gustafson, Thane. *Wheel of Fortune: The Battle for Oil and Power in Russia*. Cambridge, Massachusetts: Belknap Press of Harvard University, 2012. 90-91.

[36] Gustafson, Thane. *Wheel of Fortune*. 95.

Vultures Swoop In

In the early 1990s, Anatolii Chubais was a government official working for the State Property Committee. He, along with several reform-minded economists on his team, developed and oversaw the official privatization of the oil industry. In order to dispel significant broad opposition to the sale of state assets, Chubais distributed free vouchers to the public. Each voucher was worth 10,000 rubles, approximately $25 at the time, and was meant to be bought and sold on a secondary market and eventually exchanged for shares in the new private oil majors.[37] The remaining stakes in the companies were to be auctioned off. While the plan largely succeeded in mollifying the public, the oil bosses were more skeptical. The plan set off a scramble to obtain enough vouchers to own a controlling stake in the companies.[38]

Recall that while the legislation signed by Yeltsin to halt the fragmentation of the oil industry by creating holding companies gave the Kremlin a 45% stake in each, the legal arrangement was still quite loose; it did not give the government controlling interest, nor did it require that the *ob"edineniia* bosses relinquish their ownership. This created an ambiguous dual level of ownership, first at the consolidated level of the holding company, and second at the de facto subsidiary level of the *ob"edineniia*. Since the *ob"edineniia* were technically legally autonomous, their privatization auctions ran in parallel with the 'parent' holding companies, creating both risk and opportunity for the

[37] Freeland, Chrystia. *Sale of the Century: Russia's Wild Ride from Communism to Capitalism*. New York, N.Y: Crown Business, 2000. 59.
[38] Blasi, Joseph, Maya Kroumova, and Douglas Kruse. *Kremlin Capitalism: Privatizing the Russia Economy*. Ithaca, NY: Cornell University Press, 1997. 46-47.

holding company executives seeking to transition their management of a loose association of assets to firm ownership of a vertically integrated company.

On one hand, the executives feared that the *ob"edineniia* would cobble together sufficient stake in the subsidiary auctions to acquire de facto veto power over the decisions of the parent company within which the subsidiary asset was housed. On the other hand, the executives saw an opportunity to use their connections to the State Privatization Committee, the *Gosudarstvennyi Kommitet Imushchestva* (GKI), to purchase enough vouchers on the secondary market to establish ironclad control over the parent companies and their *ob"edineniia* subsidiaries. However, successfully acquiring sufficient vouchers required knowledge of finance and markets, an area of expertise best found in the emerging oligarchs. Executives that partnered with inexperienced or, even worse, nefarious advisors did not cement control over their assets as they wanted. Instead, many of them fell into debt and had to appeal to their oligarch advisors for financial support in return for greater stake in their companies.

The emerging oligarchs had another aspect to their plan. It was not only the oil companies that were in financial dire straits; the Russian government was in trouble of its own. Sensing the state's weakness, the financiers used their access to capital to provide rapid cash injections into state coffers. Author Martin Sixsmith notes that in one instance on March 30, 1995, two tycoons, Mikhail Khodorkovsky and Vladimir Potanin, offered the equivalent of $1.8 billion to President Boris Yeltsin in return for the right of first refusal at state asset auctions. It was, in effect, private citizens offering loans in return for preferred access to shares of state assets. It became known as the *loans-for-shares* scheme.[39] Other financiers, seeing that the shares were undervalued, bought many of them very cheaply. This privatization process cemented the transfer of state assets to the emerging oligarchs. Only the oil companies that consolidated ownership quickly – LUKoil and Surgutneftgaz – avoided being included in the loans-for-shares scheme that saw their assets sold to the oligarchs for pennies on the dollar when the voucher auction completed.[40]

The voucher auction was intended to ensure that the public-at-large felt included in the process and realized some benefit from the privatization of the state's vast oil assets. Remarkably, a handful of the richest new financial barons navigated the process through skill and influence to grow their personal wealth beyond imagination and as such, graduated from nascent financiers to full-fledged oligarchs. In this sense, the early 1990s – marked by the scramble for export permits and loans – exposed many traditionally technically-minded executives and oil bosses as unprepared for the transition to a market-based, financiers' world. This process shaped the industry and colored the legitimacy of the oligarchs in the eyes of the public and the Kremlin.

LUKoil and Yukos: Case Studies in Differing Privatization Paths

Each company pursued its own strategy through the privatization process, leading to markedly different results. Of the four big holding companies created by Boris Yeltsin in 1992, two of them, LUKoil and Yukos, represent almost polar opposite strategies,

[39] Sixsmith, Martin. *Putin's Oil: The Yukos Affair and the Struggle for Russia*. New York: Continuum, 2010. 34.
[40] Gustafson, Thane. *Wheel of Fortune: The Battle for Oil and Power in Russia*. Cambridge, Massachusetts: Belknap Press of Harvard University, 2012. 109

leading to very different outcomes. LUKoil maintained a decent relationship with the government and stayed in the hands of the *neftianiki*. While Surgutneftgaz followed a similar path, LUKoil led the way in this strategy and as such offers a particularly valuable example. In contrast, Yukos took a different tack. Its managers seemed to purposefully and shamelessly antagonize the Kremlin. The fourth holding company, Rosneft, will be discussed later in this study, as it took on a life of its own.

LUKoil is perhaps the greatest success story that came out of the privatization process. This is largely due to keen foresight and astute management. LUKoil was managed by Vagit Alekperov, the very brains behind the 1992 decree that created it. Alekperov learned the nuances of the financial industry quickly, allowing him to resist relying on the oligarchs for support where others in the Soviet old guard could not. He quickly realized that in a market economy the key to a company's value is not necessarily the strict monetary value of its assets, but the holistic value of the company itself. That is, intangibles such as steady management and cohesiveness in and of themselves increase the stock price. As such, Alekperov saw that the best way to maintain his management position – thereby increasing his own wealth – was not to be greedy and hoard stake in the company, but instead to spread shares around to key players. By making sure that the managers of the subsidiary enterprises that fell under LUKoil had financial skin in the game, he stifled their desires to more forcefully assert themselves. They too understood that having Alekperov's hand on the tiller helped buoy the LUKoil stock price and thus their own bank accounts.[41]

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[41] Gustafson, Thane. *Wheel of Fortune*. 109-110

In addition to staving off internal power struggles, LUKoil needed to establish the financial wherewithal to survive the privatization auctions. One key aspect of this was vertically integrating the company's ownership and operations to increase profitability. As noted earlier, there were two levels of ownership in the holding companies, the top executive level and the *ob"edineniia* subsidiary level. The upstream sector was largely under the control of LUKoil's executives. As such, practically speaking, vertical integration meant asserting control over the *ob"edineniia* managers, exports, and retail sales. In 1993 and 1994, the oil companies were still required to deliver certain percentages of their production to the domestic market. However, given the pervasive turmoil of the changing economy, customers often simply failed to pay. With debt growing just as LUKoil needed to firm up its cash base, Alekperov required customers to open an account at the bank through which LUKoil worked and prepay for deliveries. In return, LUKoil offered discounted prices. This strategy allowed LUKoil to muster the financial resources to generously compensate those in charge of its *ob"edineniia* subsidiaries, staving off a potentially ruinous ownership fight.[42]

Alekperov also pursued a strategy for the upstream sector. A native of Azerbaijan, Alekperov saw the territory's recent independence as an opportunity the diversify LUKoil's asset base abroad. While Azerbaijan's new President, Heydar Aliyev, was skeptical of allowing a Russian company, however separate from the Kremlin, to gain significant influence in the country's large offshore resource base, he did allow some involvement. LUKoil thus took a 10% stake in the newly formed Azerbaijan International

[42] O'Sullivan, Stephen. *LUKoil: Leader of the Pack*. London: MC Securities, September 1995. 63.

Oil Consortium (AIOC).[43] By 1996, LUKoil had acquired interest in various plays[44] throughout the former Soviet Union, the Middle East, and North Africa.[45]

In addition to deftly navigating the upstream landscape through diversification of LUKoil's assets, Alekperov also carefully monitored the opinions of the industry within the Kremlin. As a member of the Soviet oil industry, Alekperov understood how important oil was to the state and that it was Moscow that ultimately owned everything from the resources in the ground, to the pipelines traversing the vast Russian landscape, to the export permits needed to access markets. Perhaps most importantly, the bureaucrats in Moscow still envisaged oil as a tool of foreign policy. This understanding of the government relationship helped inform Alekperov's decision not to take part in the Baku-Tbilisi-Ceyhan pipeline, a project that seemed a Trojan horse for Western influence and rustled feathers in the Kremlin.[46] Through this strategy, Alekperov kept LUKoil from the oligarchs, grew its value, and stayed on good terms with the state.

While LUKoil exemplified a unique *neftianiki* success story, Yukos proved demonstrative of the oil bosses' broader inability to maintain control through privatization. The first president of Yukos was Sergei Muravlenko, a well-known oil manager from West Siberia. Muravlenko's father was well known in the oil industry for discovering vast oil deposits in West Siberia and being the first head of production in the

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[43] LeVine, Steve. *The Oil and the Glory: The Pursuit of Empire and Fortune on the Caspian Sea*. New York: Random House, 2007.
[44] In oil and gas industry parlance, a *play* is an area in which hydrocarbon accumulations or prospects are located.
[45] Gustafson, Thane. *Wheel of Fortune: The Battle for Oil and Power in* Russia. Cambridge, Massachusetts: The Belknap Press of Harvard University Press, 2012. 119.
[46] Morningstar, Richard. "From Pipe Dream to Pipeline: The Realization of the Baku-Tbilisi-Ceyhan Pipeline." Lecture, The Belfer Center for Science and International Relations, Cambridge, Massachusetts, May 8, 2003.

Tiumen region. His son's career path followed the traditional Soviet track through technical training at the Tiumen Industrial Institute and up through the Soviet oil technocracy. In 1988, Muvalenko was named general director of Yuganskneftgaz, one of the largest and most profitable oil companies in West Siberia. Muravlenko was technically savvy, but lacked the ruthlessness to be an effective manager in the roughshod, relationship-driven environment of the Soviet oil industry. This weakness was particularly apparent in the chaos of industry privatization.[47]

In the early 1990s, Muravlenko recognized that some of the NGDU-level assets underneath him wanted independence from Yuganskneftgaz. One of these assets, the Priobskoe field, was massive. While not in production at the time, maintaining control of Priobskoe was still critical. The field was tremendously valuable and, in fact, is still one of the top producing fields in Russia today, over twenty-five years later.[48] Muravlenko tried to pursue the same strategy of vertical integration as Vagit Alekperov at LUKoil by purchasing a downstream component, the Samara refinery group. After the purchase, Muravlenko renamed the new company Yukos.

In its early years, Yukos lacked structure and direction from its management. The Samara refinery group had internal conflicts that became Yukos' problem after the purchase. This gave Muravlenko additional friction to worry about. Meanwhile, the financial advisors on the Yukos team proved to be inept, leaving the company without a coherent strategy. The downstream dysfunction hindered the company's ability to shore

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[47] Gustafson, Thane. *Wheel of Fortune: The Battle for Oil and Power in* Russia. Cambridge, Massachusetts: The Belknap Press of Harvard University Press. 2012. 129.
[48] "Russia." The United States Energy Information Administration. July 28, 2015. https://www.eia.gov/beta/international/analysis_includes/countries_long/Russia/russia.pdf.

up cash flow, which in turn prevented the management from having the resources needed to acquire the shares that were owned at the NGDU level. Without consolidating ownership of the NGDU subsidiary assets, Muravlenko postponed offering shares in the Yukos parent company, fearing his weak position would lead to a broader takeover. Unfortunately, without issuing shares, Yukos severely lacked capital.[49]

By 1994, Yukos was in chaos. Yuganskneftgaz, still Yukos' largest upstream entity, could only operate 54% of its wells, with the other 46% either broken or shut-in. Management simply did not have the funds to repair them.[50] In addition to flagging production, organized crime pervaded the downstream operations of Samara, hurting the company's revenue stream even further.[51] Eventually, Yukos could not pay its suppliers, workers, or, worst of all, its taxes. In a last ditch effort to save the company, Muravlenko entered into an agreement with Amoco to develop the prized Priobskoe field. The complex geology of Priobskoe and a preponderance of more easily developable plays kept Soviet oilmen from developing Priobskoe previously, resulting in a need for foreign technology in addition to project capital. However, the agreement signed by Muravlenko allowed Amoco to, in industry jargon, recover *cost oil* before Yukos could benefit from *profit oil*. In laymen's terms, the contract allowed Amoco to recover its capital expenditures on the project through product sales *before* Yukos would experience any profit.

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[49] Gustafson, Thane. *Wheel of Fortune: The Battle for Oil and Power in* Russia. Cambridge, Massachusetts: The Belknap Press of Harvard University Press. 2012. 130-31.
[50] Gustafson, Thane. *Wheel of Fortune*. 131.
[51] Bower, Tom. *Oil: Money, Politics, and Power in the 21st Century*. New York: Grand Central Pub., 2009. 127.

This did little to help Yukos' pressing cash shortage. Indeed, the agreement was not lucrative enough soon enough for Muravlenko to maintain control of the company. His inability to secure Yukos' revenue stream and consolidate ownership made the company a prime target for takeover. Yukos was auctioned off on December 8, 1995. Mikhail Khodorkovsky, one of the two financiers who extended a loan to the state in March 1995 used the opportunity and the favor he curried with President Yeltsin to purchase 78% of Yukos through a shell company for just over $309 million.[52]

Conclusion

The government effort to halt the centrifugal forces tearing apart the oil industry in the early 1990s represented good intentions and astute crisis management. However, in the three years between the formation of the four holding companies in 1992 and the oil asset auction in 1995, the holding companies took wildly different paths. LUKoil was able to quickly consolidate ownership by rectifying poor cash flows, proving to be one of the few examples of *neftianiki* success during this time period. Nonetheless, the inability of the vast majority of the oil bosses to quickly grasp important finance and free market concepts paved the way for increased influence of the oligarchs, the most glaring example of this failure being the takeover of Yukos by Mikhail Khodorkovsky. As the industry developed over the next several years, many factors influenced the relationship between the private companies and the state. However, the corrupt nature of the privatization process never fully left the minds of those controlling the Kremlin.

[52] Sixsmith, Martin. *Putin's Oil: The Yukos Affair and the Struggle for Russia*. New York: Continuum, 2010. 35.

Chapter III: Growing Pains (1996-1997)

After the Russian state auctioned off its oil assets, management of the new private companies turned its focus toward increasing profitability. As reform-minded financiers – members of the new oligarch class – the owners understood the benefits of engaging with foreign oil companies and oil service firms. Executives believed they could increase the hard value of their assets by bringing in physical improvements such as advanced drilling technology and oilfield management expertise. Additionally, they believed that working with Westerners would further boost stock prices by lending credibility to their exploration and development projects despite the uncertainty of the Russian business landscape at the time. However, the introduction of Western companies into the Russian oil sector uncovered a chasm in how the two industries developed over several decades of separation.

Many Western oil companies believed that the Russian companies would prove great partners that were open to learning how to increase the profitability of their operations. This was mostly true at the executive level. However, relationships at the working level were fraught with much more consternation. The Westerners underestimated the cultural differences between themselves and their new business associates. Old Soviet pride died hard, and the influx of brash Texans arriving en masse to show a proud Russian oil workforce how to best develop and manage its resources proved to exacerbate an already difficult business environment. This chapter elucidates the early years of the privatized Russian oil industry, and specifically how the fundamental differences between the Russian and Western players regarding how to manage the oil resources led to macro-level difficulty in industry development and relations with the state.

Same Oil. Different Business.

Broadly speaking, the reasons why the Western and Russian oil industries developed so differently in the 20th century can be grouped into two categories: technological development and the incentive structure of the command economy. Throughout the history of oil production in Russia, exploration and production were relatively easy.[53] The industry progressed from one region with plentiful, easily-accessible oil to the next. The first region was in modern day Azerbaijan. The strategic value of the oil resources of the South Caucasus played a key role in Adolf Hitler's decision to pursue Operation Barbarossa and invade the Soviet Union during World War II.[54] However, as demand grew and production from around Baku subsided, the Soviets found a prime replacement in the Volga-Urals region. Here, the industry found similarly

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[53] Bower, Tom. *Oil: Money, Politics, and Power in the 21st Century*. New York: Grand Central Pub., 2009. 91.
[54] Yergin, Daniel. *The Prize: The Epic Quest for Oil, Money, and Power*. New York: Simon & Schuster, 1991. 334-336.

favorable geology and operation conditions. Geologists soon found expansive resources in the region adjacent to the Volga-Urals, West Siberia. For the last half-century, West Siberia has been the central locus of Soviet oil production.[55]

The Soviet Union boasted significant technical and scientific prowess. However, due to the abundance of such favorable geology, Soviet oilmen did not have much of an impetus to develop advanced extraction technology or analytics.[56] The extent of the technological gap between Russia and the West was not fully realized until the 1990s. A 1992 U.S. government survey of the Russian oil industry found that productivity across the board was between 10 and 30 percent of Western levels.[57] This was unimaginable to some of the U.S. industry consultants involved in the project. In the report, some of the consultants found equipment donated to the Soviet Union under the Lend-Lease Act and analog wire-line equipment that the West had replaced with digital tools over two decades earlier.[58] The most critical technological difference was in exploration. The Russians severely lacked seismic technology and the computing power needed for large-scale data processing. This resulted in a significantly lower success rate for wells sunk. In fact, the U.S. government-commissioned report found that the number of barrels of oil discovered per kilometer of seismic survey was about one-fifth of the global average.[59]

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[55] Grace, John D., *Russian Oil Supply: Performance and Prospects*. Co-published with the Oxford Institute for Energy Studies. Oxford: Oxford University Press, 2005. 36-41.

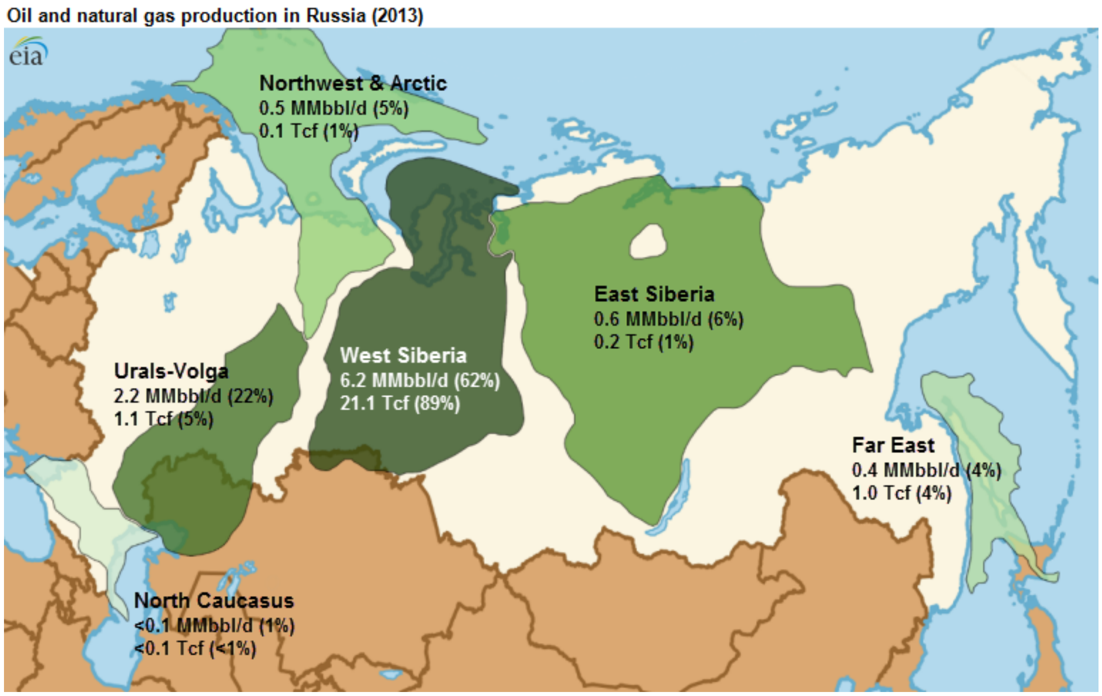
[56] Bower, Tom. *Oil: Money, Politics, and Power in the 21st Century*. New York: Grand Central Pub., 2009. 91.

[57] Gustafson, Thane. *Wheel of Fortune: The Battle for Oil and Power in* Russia. Cambridge, Massachusetts: The Belknap Press of Harvard University Press. 2012. 151.

[58] Spears and Associates, *Petroleum Equipment and Service Needs of the CIS*. Tulsa, OK: Spears and Associations, April 1992.

[59] Spears and Associates, *Petroleum Equipment and Service Needs of the CIS*. Tulsa, OK: Spears and Associations, April 1992.

Figure 2: Regions of Oil and Natural Gas Production in Russia



Source: United States Energy Information Administration, 2014. http://www.eia.gov/todayinenergy/detail.cfm?id=18051.

The dearth of technological innovation was not the only significant factor in stifling the development and productivity of the oil industry during the Soviet era. In fact, perhaps an even larger factor was the distorted incentive structure of the command economy. As previously noted, the industry was strictly managed from the upper ranks of the Kremlin. This created a great deal of waste. For example, a common Soviet metric for oil industry success was not barrels of oil produced, but meters of well drilled. As a result, drilling was not a means to an end, but practically an end in and of itself. Compounded with inadequate reservoir modeling and well logging, oilmen drilled a staggering number of wells that punched straight through oil-bearing rock without realizing it. With drilling as a primary metric, many wells were drilled and cased, but never perforated or produced.[60]

During the Soviet era, the oil industry was, first and foremost, a tool of the state. This affected the development of the oil industry by skewing production incentives; targets were dictated by bureaucrats more interested in meeting policy goals than maintaining the long-term value and sustainability of the oilfields. The conflict between state goals and industry health appeared in stark relief in the latter half of the 1980s. Crude oil prices reached $87.65 (2005 prices) in 1980. In 1986, they fell to $25.63 and more or less remained between $25 and $35 from 1986 to 1992.[61] During this period, in an example of the state imposing production strategy on the oil industry, the Kremlin demanded more production in order to make up for the loss in revenue per barrel. Petroleum engineers needed to find a way to extract much more oil out of their inefficient wells. The result was excessive waterflooding.

Waterflooding is a technique in which water is pumped into injector wells that are drilled adjacent to production wells in order to create a wall of water that pushes oil toward the production wells. When used properly, water injection is a valuable enhanced recovery technique. However, when used without appropriate reservoir analytics in order to hastily and drastically increase production, waterflooding can severely damage wells. Though waterflooding does not create artificial fractures like fracking, the injected water

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[60] Gustafson, Thane. *Wheel of Fortune: The Battle for Oil and Power in* Russia. Cambridge, Massachusetts: The Belknap Press of Harvard University Press. 2012. 38-39.
[61] BP. *BP Statistical Review of World Energy 2011*. London: BP, 2011. http://www.bp.com/content/dam/bp-country/de_de/PDFs/brochures/statistical_review_of_world_energy_full_report_2011.pdf

can seep through naturally-occurring fractures in the source rock and lead to an ever-increasing percentage of water recovered with the oil.[62] By one estimate, waterflooding left 80% of Russian wells contaminated.[63] That sort of damage was not inflicted upon wells in the West because the main driver of production was profit, not achieving the policy objectives of the state. The differences in technology and industry incentives reveal two particularly broad or 'macro-level' tensions between the Russian oil companies and the Western oilmen: damaged egos and investment instability.

Macro-level Tensions

When the Russian oil industry opened up to Western involvement, the foreign oil workers created significant tension between themselves and the Soviet oilmen by not being cognizant of the natives' pride. The Soviet oilmen developed a level of geological knowledge similar to their Western counterparts despite a lack of advanced tools.[64] They worked in a successful industry of strategic importance that afforded them a laudable reputation in their communities. However, the Western oilmen viewed the oil industry in Russia very differently. After seeing the outdated technology and wildly inefficient practices, the Westerners were quick to recommend sweeping changes. They were incredulous at the level of waste, with one Western intelligence service even producing an analysis comparing the oil Russian oil industry to that of an impoverished West

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[62] Hedlund, Stefan. *Putin's Energy Agenda: The Contradictions of Russia's Resource Wealth*. Boulder: Lynne Rienner, 2014. 173-174
[63] Bower, Tom. *Oil: Money, Politics, and Power in the 21st Century*. New York: Grand Central Pub., 2009. 91.
[64] Bower, Tom. *Oil*. 93.

African country.[65] The brash attitudes of the foreigners betrayed their true feelings hiding behind a thin veneer of insincere politeness. In the wake of the humiliating collapse of the Soviet Union, Russian oilmen swallowed their pride in order to access much needed equipment and expertise. However, as author Thane Gustafson explains, their willingness to be treated as "a defeated country, wide open for sale"[66] had limits.

The second macro-level tension between Russia and the West was the poor investment climate. When the Iron Curtain fell, Russia was just one of many countries that became open for new investment. Azerbaijan invited Western majors to participate in the development of offshore plays in the Caspian while Kazakhstan sought investment in its massive Tengiz field.[67] These fields offered intriguing, new reserves that allowed foreign majors to get in on the ground floor. The issues with these plays were primarily geological.

Conversely, the Russian investment opportunities were onshore in the Volga-Urals region and West Siberia. The reservoirs were well understood and in many cases already producing. As such, the primary investment risks in Russia were not geological, but political. The Western executives felt that investing large sums of money into finding technical solutions could solve the geological problems characterizing the Azerbaijani and Kazakh plays. Meanwhile, the non-technical concerns in the Russian market required the companies to build relationships, a time-consuming process. Furthermore, without

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[65] Bower, Tom. *Oil*. 93.
[66] Gustafson, Thane. *Wheel of Fortune: The Battle for Oil and Power in* Russia. Cambridge, Massachusetts: The Belknap Press of Harvard University Press. 2012. 152.
[67] Bower, Tom. *Oil: Money, Politics, and Power in the 21st Century*. New York: Grand Central Pub., 2009. 96.

confidence in the rule of law or a contract arbitration system, Western executives perceived an increased risk of asset expropriation.

Another factor that contributed to the initial investment calculus of the Western majors was ease of export. The former Soviet republics, located on the Russian periphery, offered access to an existing network of oil and gas pipelines and relatively short distances to export markets. Russian fields, particularly those located in West Siberia, were remote and necessitated the use of the Transneft pipeline infrastructure. This was highly undesirable due to the fact that the Russian government owned Transneft and controlled access to both the physically-limited capacity of the infrastructure and the permits required for export. As a result, the newly independent former Soviet republics attracted significantly greater initial investment from Western companies than did Russia.[68]

Western companies seeking to invest in Russia also experienced instability and informality in the business environment. Navigating this required strong relationships with and guidance from government officials. In a country with such complicated, opaque politics and informal patronage networks, this was incredibly difficult. Some Westerners relied on the smaller, more easily navigable, regional governments. However, the frequently changing authorities did not mollify the investment instability. Of course, working with the Kremlin was no better. The various players in Moscow made pursuing business deals there fraught with personal tensions and conflicting political interests. As frustrating as it was for the Western companies to navigate the conflicts between the

[68] Gustafson, Thane. *Wheel of Fortune: The Battle for Oil and Power in* Russia. Cambridge, Massachusetts: The Belknap Press of Harvard University Press. 2012. 173-174.

various Russian interest groups, it was even more difficult to overcome the one thing that unified the Russians: an intense skepticism of the West. Thane Gustafson elucidates this fact through a Russian saying: "He who interferes in a fight between brothers will be beaten by both, and rightly."[69]

Aside from navigating the network of complex relationships, Western companies struggled to gain clarity and confidence regarding the tax structure covering their business deals. The Westerners wanted the Kremlin to approve the use of production sharing agreements (PSAs) as the standard form of contract used. PSAs offered several advantages to the Westerners, including the ability to use outside (e.g. United States) legal jurisdiction for tax and property law purposes, and the right – as previously noted – to recover cost oil. The Kremlin opposed the use of PSAs because they were generally the types of contracts that were used when doing business in countries with high "political" risk. While Russia resented being treated as a third world country, there was also a more practical reason for their reluctance to grant PSAs; Russia needed to increase its oil revenue *quickly*. If the Kremlin allowed the Westerners to recover cost oil in order to offset the risk of their investment, Russia would have to wait years to see any significant payback from the projects. This was simply a non-starter for a cash-strapped Russian state.[70]

[69] Gustafson, Thane. *Wheel of Fortune*. 175.
[70] Gustafson, Thane. *Wheel of Fortune*. 176-181.

Conclusion

The influx of Western involvement that occurred in the wake of the privatization of the Russian oil industry exposed two very different oil industries. Despite a similarly talented technical workforce and favorable geology, the top-down nature of the command economy removed any significant impetus for the Russian oil industry to develop new technology or operate efficiently. The result was an oil industry in tatters. In 1989 alone, 51 million barrels of oil leaked into rivers simply because the government could not be bothered to repair corroded pipes.[71] Western majors saw the newly privatized Russian market as a tremendous opportunity for a mutually beneficial relationship. However, cultural differences and open Cold War wounds led to damaged pride while nebulous property rights and tax laws created an unstable business environment.

These macro-level tensions permeated the industry relationships in the early years of the private Russian oil industry. When Russian oil production bottomed out in 1997 falling to approximately half of the Soviet-era peak,[72] suspicion in the Kremlin regarding Western involvement in the industry only grew. What happened next to the Russian economy proved to be another critical pivot point in the minds of those skeptical leaders, one that significantly altered the course of the Russian oil industry and its relationship to the state.

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[71] Bower, Tom. *Oil: Money, Politics, and Power in the 21st Century*. New York: Grand Central Pub., 2009. 94.

[72] Gustafson, Thane. *Wheel of Fortune: The Battle for Oil and Power in* Russia. Cambridge, Massachusetts: The Belknap Press of Harvard University Press. 2012. 183.

<u>Chapter IV: From Challenge to Chudo (1998-2002)</u>

The adversity faced by Russian oil throughout the privatization process and the introduction of Western companies in the mid-1990s was nothing compared to the tumult of the late-1990s and early-2000s. During that period, the Russian oil industry followed a similar trajectory to the broader economy: a challenging collapse to rock bottom followed by a miraculous comeback, or *chudo*, in Russian. The stagnation of oil production, fall into economic recession, and the ultimate recovery of both are critical to understanding the further development of the relationship between the Russian oil industry and the state.

<u>Challenge</u>

In 1996 and 1997, the Kremlin was optimistic about the economic prospects of the country. Despite a lethargic oil industry, the trade imbalance was moving from deficit to surplus; relationships with the World Trade Organization (WTO) and International Monetary Fund (IMF) were strengthening, with the former agreeing to provide $2-$3 billion in aid per year; inflation fell from 131% in 1995 to 22% in 1996; and the ruble remained stable through a tight currency band pegged to the U.S. dollar. Additionally, Russia came to terms on renegotiating the repayment schedule of tens of billions of dollars borrowed during the Soviet era.[73] Russia's increased integration into the global financial system provided reasons for long-term optimism. However optimistic, the Russian economy was still weak and the same integration into the global economy also exposed Russia to the risks of financial tumult in previously far-flung regions of the world.

That vulnerability to economic disorder bore fruit in the form of the "Asian Flu." In July 1997, a lending bubble that built over-confidence in several emerging markets in Asia burst. The capital flight that began with a run on the Thai baht spread throughout Asia, sending other countries such as Malaysia, Hong Kong, and the Philippines into recession.[74] In November 1997, currency speculators lost faith in the ruble, causing the Kremlin to spend $6 billion in foreign reserves to prop up the economy. As the tumult spread further from its source region, the global economy slowed down, leading to a drop in demand for raw materials, including metals and oil, industries that accounted for two-thirds of the Russian economy.[75] In December 1997, these commodity prices plummeted, hitting Russia particularly hard.

1998 was an extremely difficult year for the Russian economy. From May to August, capital flight totaled $4 billion on rumors of an impending ruble devaluation from the Russian central bank. An additional $4 billion in revenue was lost in the same time frame due to flagging oil prices, which averaged $12 per barrel, half the price of the

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[73] Chiodo, Abbigail J. and Michael T. Owyang. "A Case Study of a Currency Crisis: The Russian Default of 1998." Federal Reserve Board of St. Louis. February 2011.
[74] Corsetti, Giancarlo, Pesenti, Paulo, and Roubini, Nouriel. "What Caused the Asian Currency and Financial Crisis?" *Japan and the World Economy* 11 (1999): 305-373.
[75] Chiodo, Abbigail J. and Michael T. Owyang. "A Case Study of a Currency Crisis: The Russian Default of 1998." Federal Reserve Board of St. Louis. February 2011.

previous year. Revenues flowing into the Russian treasury slowed to a trickle, falling almost 40% in just two years, from $23 billion in 1996 to $14 billion in 1998.[76] On August 17, 1998, the Russian economy collapsed. Yields on ruble-denominated bonds reached 200% and the government was forced to abandon the currency band and devalue the ruble. The decision capped an eight-month period beginning in January that saw the Russian stock market lose more than 75% of its value.[77] The Kremlin could not continue to finance its budget deficits. Each day, the treasury was searching for new lenders simply to find the liquidity to pay off earlier lenders.[78] The result was a devastating government default.

Liberals and conservatives in the government drew very different lessons from the collapse. While liberals took the default as impetus to open and strengthen markets further, conservatives came to the opposite conclusion. They perceived a failing of several Western ideas and institutions. For example, the IMF left Russia after failing to reach an austerity agreement. The Central Bank of Russia lacked the liquidity it needed to purchase its own government bonds in part because the state recently reorganized the treasury system to mirror the United States.[79] For conservatives, the collapse of the economy represented not just growing pains for a new market economy, but the failure of

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[76] Gustafson, Thane. *Wheel of Fortune: The Battle for Oil and Power in* Russia. Cambridge, Massachusetts: The Belknap Press of Harvard University Press. 2012. 183.
[77] Chiodo, Abbigail J. and Michael T. Owyang. "A Case Study of a Currency Crisis: The Russian Default of 1998." Federal Reserve Board of St. Louis. February 2011.
[78] Goldman, Marshall I. *Petrostate: Putin, Power, and the New Russia*. Oxford: Oxford University Press, 2010. 75.
[79] Chiodo, Abbigail J. and Michael T. Owyang. "A Case Study of a Currency Crisis: The Russian Default of 1998." Federal Reserve Board of St. Louis. February 2011.

the capitalist experiment itself. This skepticism contributed to their desire to revert to centralized state control of the economy.

As the conservatives in the Kremlin who were historically skeptical of Western involvement in the oil sector looked out over the landscape of the Russian economy, they observed two things: an oil industry whose production plummeted by 40% during the first eight years of growing Western involvement from 1990 to 1998; and an economy in ruin.[80] Where was the oil and money that was supposed to result from Western technology and business acumen? The recently-appointed Prime Minister, Vladimir Putin, viewed western economic advice and, to a certain extent, western oilfield management advice, as a Trojan horse being used to wreak havoc on Russia and cement U.S. economic and global superiority.

The Economy Turns Around

The 1998 sovereign debt default was catastrophic for many aspects of the Russian economy. However, it was not without a silver lining. If the Russian economy in the mid-1990s suffered from a fever, the default and subsequent rapid devaluation of the ruble represented the moment that fever broke. The debt held by Russian oil companies was primarily denominated in rubles. When the Kremlin defaulted on $40 billion of foreign debt and floated the currency, the ruble devalued fourfold. The devaluation alone amounted to a de facto 75% cut in the liabilities of Russian oil companies almost

[80] Goldman, Marshall I. *Petrostate: Putin, Power, and the New Russia*. Oxford: Oxford University Press, 2010. 77.

overnight.[81] Simultaneously, the price of oil quickly rebounded due to shifts in the global market, almost tripling from $12 per barrel in 1998 to $33 per barrel in 2000.[82]

The effects of this turnaround cannot be overstated. In 1998, Russia brought in $74 billion in export revenues, with $28 billion (38%) coming from oil and natural gas. Just seven years later in 2005, total export revenue increased over three times to $243 billion, of which $143 billion (59%) was the result of oil and natural gas sales.[83] In 2006, Russia pumped more oil than Saudi Arabia. By 2007, less than a decade after chaos and default, the Kremlin boasted the third largest reserves of foreign currency and gold, with $420 billion in the treasury.[84]

Aside from helping the economy turnaround quickly, the devalued ruble and rising oil prices provided an influx of cash to the industry that allowed for much needed capital investment. Due to the damage done to oilfields throughout the Soviet era, the first sector that Western companies targeted for rehabilitation were the brownfields. To do so, the industry used the cash dividend from the economic recovery to invest in and employ Western technologies and oilfield management practices. This process was wrought with conflict, perhaps a battle foreshadowed by the post-privatization/pre-recession macro-level tensions between the market-minded oligarchs with Western support and the old guard *neftianiki* with state backing. The deep integration of Western

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[81] Gustafson, Thane. *Wheel of Fortune: The Battle for Oil and Power in* Russia. Cambridge, Massachusetts: The Belknap Press of Harvard University Press. 2012. 185-186.
[82] Goldman, Marshall I. *Petrostate: Putin, Power, and the New Russia*. Oxford: Oxford University Press, 2010. 77.
[83] Gustafson, Thane. *Wheel of Fortune: The Battle for Oil and Power in* Russia. Cambridge, Massachusetts: The Belknap Press of Harvard University Press. 2012. 187-188.
[84] Goldman, Marshall I. *Petrostate: Putin, Power, and the New Russia*. Oxford: Oxford University Press, 2010. 80.

technology and business practices needed to arrest the decline in oil production was almost antithetical to the Soviet legacy oil workers and conservatives in government. The most useful and illustrative example of both the benefits of Western involvement and the conflict with the state is the only company to quickly and fully institute Western practices: Mikhail Khodorkovsky's Yukos.

The Anatomy of a 'Chudo'

Throughout late 1997 and most of 1998, Yukos was at risk of failure. Its balance sheet reflected the aforementioned ruble depreciation dividend, but with historically low oil prices and poorly performing assets, Khodorkovsky did not have revenue to pay his employees or his taxes. One industry expert close to Yukos in 1999 recalled that Khodorkovsky paid his employees in television sets and used questionable tactics to limit his tax obligations. He needed to increase Yukos' oil production. In October 1998, Khodorkovsky signed a contract with the Western oil service company Schlumberger. Under this arrangement, the opportunity to advise and manage Yukos was virtually carte blanche. Not only did Schlumberger provide equipment and technical expertise, it also reformed business operations and personnel decisions.

The person sent by Schlumberger to institute these changes was Joe Mach, a seasoned industry expert with an oversized personality. Mach used computers to monitor well pressure and flow rates throughout the entire reservoir in order to determine precisely where, at what "nodes," production bottlenecks occurred. This strategy allowed Schlumberger to offer Yukos a detailed report on the state of its assets and recommendations for specific tactics to employ in each well. Furthermore, with this nodal analysis, Yukos catalogued and compared the actual measurements at all the wells to their theoretical production potential to determine their "performance gaps." This allowed Mach to not only suggest a course of action for each well, but to also rank in order the wells that should be targeted first. Schlumberger recommended three broad technical courses of action for Yukos: installing more powerful well pumps, using more advanced hydraulic fracturing (fracking), and reversing the damage from waterflooding. The wells with the largest performance gaps were targeted first.[85]

Throughout the Soviet era, petroleum engineers injected water into wells as a standard secondary recovery method. When the proportion of water to oil became too high, the Soviets installed electrical submersible pumps (ESPs) in order to drive oil up the wellbore more cost effectively. Over time, these pumps became ubiquitous throughout West Siberia.[86] By the time Schlumberger arrived, the ESPs were grossly outdated for two reasons: first, they were not powerful enough to be effective, and second, they failed under high heat, thus precluding them from being set as deep in the well as they needed to be.

Prior to the 1998 default, new Western ESPs were prohibitively expensive, around $80,000 per unit. After the ruble devalued, the price of Russian-made ESPs plummeted to the equivalent of $10,000 per unit since they were valued in cheaper rubles. However, after a decade of atrophy, Russian manufacturers did not have the capacity to retool and make Western-quality pumps. The oil companies decided to step in

[85] Gustafson, Thane. *Wheel of Fortune: The Battle for Oil and Power in* Russia. Cambridge, Massachusetts: The Belknap Press of Harvard University Press. 2012. 200-205.
[86] Goldman, Marshall I. *Petrostate: Putin, Power, and the New Russia*. Oxford: Oxford University Press, 2010. 34.

and invest in the domestic pump manufacturers. Between 2000 and 2003, the Russian ESP makers increased the quality of their products and capacity for production enough to provide over 50,000 new pumps for domestic use, replacing almost all of the Soviet-era machinery.[87]

Mach met resistance in his plan for Yukos' pumps on two fronts. First, he demanded that the old pumps be lowered deeper into the wells. This order was met with consternation from the oil workers who knew that their ESPs were not designed to operate under that level of heat and pressure. Many pumps failed, but those that remained operational were more effective and thus largely made up for the ESPs that succumbed to stress. Second, Mach used the new Western ESPs in a way that ran contrary to a core Soviet era operating practice. ESPs cause the pressure at the bottom of the reservoir, below the pump, to drop. This can induce the natural gas that is dissolved in the oil (associated gas) to separate from the oil and bubble up to the top. Without the associated gas mixed in the oil, the well pressure drops, cutting oil production substantially. As such, the Soviet oil management prohibited ESPs to be used in such a way that the well reached the "bubble point." To this effect, fear of state repercussions deterred Soviet oil workers from operating their machinery anywhere near the bubble point.

However, the Schlumberger technicians under Mach used more advanced technology and analytics than the Soviets ever had, allowing them to operate the more powerful ESPs at or slightly below the bubble point. The old Soviet workers were horrified by the foreigners running the pump so close to the bubble point. Historically,

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[87] Gustafson, Thane. *Wheel of Fortune: The Battle for Oil and Power in* Russia. Cambridge, Massachusetts: The Belknap Press of Harvard University Press. 2012. 207.

even coming close to it was seen as too risky and could elicit punishment from the *obkom*. Consequently, while the use of analytics and stronger pumps increased overall production, the strategy still induced significant resentment from old guard management afraid of consequences from the state.[88]

In addition to purchasing better pumps, Schlumberger wanted to drastically increase the use of fracking. Traditionally, the Soviets fracked simply in order to break through layers of particularly hard cap rock and induce oil to flow to the wellbore. These "skin fracks" used approximately four to ten tons of proppant per frack and did not extend very far. Under Schlumberger's control, Yukos began fracking with up to 500 tons of proppant, creating fracks over hundreds of yards in length. Fracking on this scale might as well have been an alien concept to the oil workers at Yukos. Many of them, as well as Yukos' competitors, were furious at Schlumberger for instituting, and Khodorkovsky for allowing, this practice. They likened the super-fracks to carpet-bombing.

Finally, Joe Mach tackled the problem of waterflooding. Waterflooding is an old technique that was used by U.S. oil producers for decades. As previously discussed, the theory underpinning waterflooding is sound. The primary issue with the technique is that it is difficult to execute without advanced analytics. Without the proper data, Soviet waterflooding essentially involved surrounding a production well with several wells into which water was injected in order to drive the oil toward the center production well. This

[88] Gustafson, Thane. *Wheel of Fortune*. 206-207.

crude design, dubbed the "Siberian box," created significant production losses and led to water breaking through into the oil reservoir and contaminating the production well.

The Schlumberger team found that the wells with botched waterfloods operated at less than 8% of their theoretical production potential. Those wells not only produced more water than oil, but also were tantamount to parasites, damaging the production of neighboring wells. In order to mitigate the damage done from the waterflooding at Yukos, Schlumberger used three-dimensional seismic data to determine which wells were acting as parasites and then modeling how shutting them in might increase well pressure, and thus production.[89]

The Western recommendations worked. By 1999, Yukos was leading the Russian oil industry, boasting great steps forward in production, efficiency, and profitability. From 1998 to 2000, Yukos cut production costs by two-thirds.[90] From 1997 to 2002, Yukos doubled the average flow rates from its wells, while the rest of the Russian oil industry only managed a 14% increase. Yukos' new wells produced spectacular results. Each new Yukos well produced on average 918 barrels per day, a staggering figure compared to the 294 barrels per day seen by new wells across the rest of the industry. By 2002, Yukos' lifting costs[91] were approximately $1.47 per barrel, a full 40% lower than its nearest competitor, LUKoil, whose lifting costs were around $2.50 per barrel.[92]

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[89] Gustafson, Thane. *Wheel of Fortune*. 208-210.
[90] Sixsmith, Martin. *Putin's Oil: The Yukos Affair and the Struggle for Russia*. New York: Continuum, 2010. 41.
[91] The term "lifting costs" refers to the operating expenses associated with the physical extraction of hydrocarbons from the ground. It does not take into account pre-production costs such as exploration expenses or post-production costs such as transportation and refining.
[92] Gustafson, Thane. *Wheel of Fortune: The Battle for Oil and Power in* Russia. Cambridge, Massachusetts: The Belknap Press of Harvard University Press. 2012. 217-218.

Figure 3: Oil Production by Company, 1995-2011 (million metric tons)

	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
Russian Federation, total	307	301	306	303	305	323	348	380	421	459	470	481	491	488	494	505	511
Rosneft	**12**	**13**	**13**	**13**	**12**	**13**	**14**	**15**	**19**	**22**	**74**	**82**	**110**	**114**	**106**	**112**	**114**
LUKoil	**58**	**54**	57	57	59	62	72	74	72	84	88	86	91	88	92	90	85
TNK-BP	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	70	75	84	80	79	80	81	82
Surgutneftgaz	**33**	**33**	34	35	36	41	44	49	54	60	64	66	64	62	60	60	61
Gazprom Neft	**20**	**19**	18	17	16	17	21	26	31	34	33	**44**	**43**	**41**	**39**	**39**	**39**
Tatneft	**25**	**25**	**25**	**24**	**24**	**24**	**25**	**25**	**25**	**25**	**25**	**25**	**26**	**26**	**26**	**26**	**26**
Slavneft	**13**	**13**	**13**	**12**	**12**	**12**	**14**	**15**	18	22	24	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Bashneft	**18**	**16**	**15**	**13**	**12**	**12**	**12**	**12**	**12**	**12**	**12**	**12**	**12**	**12**	**12**	**14**	**15**
Gazprom	**9**	**9**	**9**	**9**	**10**	**10**	**10**	**11**	**11**	**12**	**13**	**13**	**13**	**13**	**11**	**14**	**15**
Russneft	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	2	7	12	15	14	14	13	13	14
TNK	**28**	**25**	**24**	22	23	29	34	38	43	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Sidanco	**18**	**15**	15	16	16	16	16	16	19	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Onako	**8**	**8**	**8**	**8**	**8**	**8**	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Yukos	**47**	**46**	47	45	44	50	58	70	81	86	25	22	n.a.	n.a.	n.a.	n.a.	n.a.

Source: Russian Ministry of Energy found in Gustafson, Thane. *Wheel of Fortune: The Battle for Oil and Power in* Russia. Cambridge, Massachusetts: The Belknap Press of Harvard University Press. 2012. 195.
n.a.: Not Applicable (company not in existence or acquired by other company or companies).
Shading font indicates years that a given company was controlled by the state.

The strategy yielded results, but not without again stirring the pot. As was seen with the ESP strategy, any plan that the oil workers feared would decrease production, however unfounded, was met with fierce skepticism. This remained the case even though the strategy *increased* overall production. The Soviet era workers believed that such strategies would elicit reprisals from the managers in the government bureaucracy. In the case of shutting in wells, the old guard had a point. Not only was this practice controversial, it was illegal. One legacy policy from the Soviet era that remained in Russia was that oil companies could not deviate from the oilfield development plan that had to be filed with the government. In this vein, the Western changes instituted at Yukos challenged very deeply entrenched views on not only how to best develop oil resources, but the state's final authority over the industry.

Tensions Rise

If the macro-level tensions that colored the post-privatization/pre-recession period from 1995 to 1998 revolved around tax regimes and broad issues of pride, the conflicts of the full Western integration into the industry stemmed from operational disagreements. These seemingly mundane decisions proved to be anathema to the Soviet legacy workforce and conservatives in the Kremlin. Western operational strategies exposed cultural differences much more fundamental than the issues that plagued the PSA negotiations. Yukos and its Western partners instituted a regime of transparency, prioritized cash flows over workers, and did so with irreverent swagger.

Khodorkovsky understood that efficiency was paramount to the survival of the company, a concept that Soviet-era workers never grappled with since the government underwrote their operations. In order to ensure that Yukos operated as efficiently as possible, Khodorkovsky had to eliminate theft and fraud. To do so, he put in place a system that recorded and displayed the flows from each well and throughout the company's production network in real time. This terrified the Yukos workers that had come up in the Soviet system. Throughout their careers, these Soviet petroleum engineers and mid-level managers kept full production data very close to their chests and away from the managers in the regional and Kremlin bureaucracies. This helped them manipulate figures and avoid reprisals when production did not meet mandates from the state. After all, data that revealed elevated production in one year only led the party apparatchik in Moscow to expect such production to continue in perpetuity. Furthermore, most of the analysts crunching numbers and monitoring the production flows were young, arrogant technologists. They sat behind computers and discovered the data that their older, more experienced counterparts had spent careers trying to keep from their superiors in Moscow. Khodorkovsky's transparency initiative represented a threatening affront to the veteran cadre working at Yukos.[93]

Khodorkovsky was also the first to begin dismantling a fundamental social contract from the Soviet era. Oil companies, as state-owned enterprises, historically existed not simply to produce oil or maintain a positive revenue stream, they existed to create jobs. After privatization, profit became king. In order to keep Yukos afloat during its period of tribulation in the late 1990s, Khodorkovsky did what was otherwise considered unthinkable: he laid off employees. In a 1998 interview transcribed in Martin

[93] Gustafson, Thane. *Wheel of Fortune*. 213-214.

Sixsmith's book, *Putin's Oil: The Yukos Affair and the Struggle for Russia*, Khodorkovsky seems to take pride in making ruthless personnel decisions, cutting the Yukos staff by 30% and mandating a 30% salary cut for the remaining 100,000 employees.[94]

Many of the laid off workers lived in remote West Siberian oil towns that relied on the oil industry for their existence. When Yukos shut down operations, the economy of these towns vanished. Even in the locations where Yukos maintained production, Khodorkovsky did not invest in social projects that were customary in the Soviet era. Yukos did not fund schools, create family housing, or build hospitals.[95] In this sense, Khodorkovsky's business decisions represented more than a superficial change of course, they represented a betrayal of the people.

The last noteworthy affront to the old hierarchy within the oil industry was less about the changes that were instituted, and more about the demographic make-up of the people involved. Of course, the fact that foreigners made many of the decisions was a significant insult to Russian pride. However, the foreigners did not hold a monopoly on criticism. Mikhail Khodorkovsky also drew the ire of the *neftianiki* within Yukos and political conservatives in the Kremlin. Both the *neftianiki* and the conservatives spent most of their careers in the top-down, rigid, command economy of the Soviet Union, in a culture of commitment to the Motherland, respect for elders, and anti-Semitism. It is no

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[94] Sixsmith, Martin. *Putin's Oil: The Yukos Affair and the Struggle for Russia*. New York: Continuum, 2010. 41.

[95] Gustafson, Thane. *Wheel of Fortune: The Battle for Oil and Power in* Russia. Cambridge, Massachusetts: The Belknap Press of Harvard University Press. 2012. 217.

wonder that they treated the young, arrogant, Jewish Mikhail Khodorkovsky with so much disdain.

David Hoffman expounds on Khodorkovsky's brash style with an anecdote in his book, *The Oligarchs: Wealth and Power in the New Russia*. Hoffman notes a book that Khodorkovsky and his business associate wrote to describe their new business in the early 1990s, Menatep Bank. This book, *Man with a Ruble* – a title meant to mock the famous Soviet play about Lenin, *Man with a Gun* – extoled the greatness of wealth and greed, stating such blasphemes as, "our idol is his financial majesty the capital" and "our compass is profit."[96] These were controversial positions even in late-1990s Russia and they did not help Khodorkovsky curry any favor with those of an older mindset.

While Yukos represented a particularly aggressive adoption of Western technology, business practices, and capitalist values, it was not the only oil company to experience gains. LUKoil and Surgutneftgaz also took advantage of ruble devaluation and higher oil prices to strengthen their revenue streams, only through less controversial methods. Vagit Alekperov at LUKoil slowly adopted Western technology and methods, but did so in a quieter, less antagonistic manner. Meanwhile, Vladimir Bogdanov at Surgutneftgaz tried to keep pace in production by doubling down on old Soviet methods and simply drilling an inordinate number of new wells. Neither company managed to achieve success close to the Yukos turnaround. However, they both increased

[96] Hoffman, David E. *The Oligarchs: Wealth and Power in the New Russia*. New York: Public Affairs, 2001. 120-121.

government disapproval of Yukos by proving it possible to achieve some level of success while staying true to the 'Soviet way.'[97]

Legacy of the Economic and Oil Recovery

Despite the more traditional methods of LUKoil and Surgutneftgaz, the great oil recovery that occurred in the late-1990s and early-2000s shattered the rigid production practices and sacrosanct worker-employer social contract of Soviet days. As Thane Gustafson describes in his 2012 book, *Wheel of Fortune*, the conservative view of Western-induced changes was that, "Tight financial and production controls were repressive… Profit maximization was predatory. Tax optimization was criminal."[98] In terms of corporate strategy, the oil industry recovery can best be characterized by the prioritization of brownfield revitalization over greenfield exploration and production. While the short-term effects were unmistakably beneficial for the companies, the long-term benefits were less clear. In prioritizing the rehabilitation of legacy assets, the oil companies neglected to invest in discovering and developing new fields. When the miraculous recovery of the brownfields ended and the oil companies had few new assets to bring online, they became vulnerable to those voices eager to criticize them.

The conservatives never wanted the oil industry privatized. They resented the upstart oligarchs making off with massive assets that they believed rightfully belonged to the state. Furthermore, they loathed the influence that Western companies gained in the latter half of the 1990s. Fortunately for the conservatives, the timing of the collapse of the

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[97] Gustafson, Thane. *Wheel of Fortune: The Battle for Oil and Power in* Russia. Cambridge, Massachusetts: The Belknap Press of Harvard University Press. 2012. 225.
[98] Gustafson, Thane. *Wheel of Fortune*. 230.

oil industry and, indeed, the broader economy coincided nicely with the 2000 election of one of their own, Vladimir Putin. Putin came to power as the Russian economy turned the corner and the oil industry began to experience its revitalization. He was not responsible for these economic good fortunes, but, an apt craftsman of public perception, he nonetheless took credit and reaped a dividend of political capital, capital he used to reverse the liberalization of the 1990s and reassert state power over the oil industry.

Chapter V: The Origins of Resource Revanchism

The 2000 presidential election in Russia was the culminating event of the meteoric rise of Vladimir Putin. In just four years, Putin went from being deputy mayor of St. Petersburg to President of Russia. The public did not know it at the time, but, with his election, Putin brought a markedly different ideology to the Kremlin. He and his inner circle – a group of conservative policymakers, many of whom were former KBG officers – represented a sharp departure from the path of economic liberalization pursued by Boris Yeltsin throughout the 1990s. This inner circle of revisionist allies and officials, known collectively as the *siloviki*, believed that the failure of the Soviet Union was a travesty. Famously, Vladimir Putin bluntly stated in 2005 that the collapse of the Soviet Union was, "the greatest geopolitical catastrophe" of the 20th century.[99]

To the *siloviki*, devolution of power in Moscow, economic openness, and shifts toward Western values represented an embarrassment of grand scale. They believed Russia's influence on the global stage was diminished and resolved to reverse that trajectory. Over time, the reassertion of state authority and ownership over the oil sector became one of the most important components of the *siloviki* strategy. In order to

[99] "Putin Deplores Collapse of USSR." BBC News. April 25, 2005. http://news.bbc.co.uk/2/hi/4480745.stm

understand the reversal of reformist policies and sudden revanchist pursuit of Russian oil resources, it is imperative to understand the years and experiences that shaped the mentality of Vladimir Putin and his inner circle.

The Siloviki Mind

The *siloviki* were not just economic conservatives opposed to liberalization, they were intimidating individuals whose previous positions in government included time in the Soviet security apparatus, the KGB, and other so-called power ministries.[100] In analyzing the mindset that Vladimir Putin brought to the Kremlin in 2000, it is useful to review some key experiences throughout his most formative years, those spent abroad as a Soviet intelligence officer; and the works of some of his favorite writers and strategic thinkers, specifically those he saw fit to send as required reading to the governors of the various Russian provinces.

Vladimir Putin accepted a position as an intelligence officer in the KGB around 1975. Details about his first post are nebulous; some believe, tellingly, that Putin worked in the Fifth Directorate, the KGB arm responsible for internal order and the suppression of dissent.[101] In 1985, Putin was posted to Dresden, East Germany, where he worked with the East German secret police, the stasi.[102] This was a tumultuous time in East Germany, with the Soviet Union rapidly changing under Mikhail Gorbachev's transformative perestroika polices and local Dresden demonstrations increasing. The Kremlin was losing

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[100] Dawisha, Karen. *Putin's Kleptocracy: Who Owns Russia?* New York: Simon & Schuster, 2015. 54.
[101] Gessen, Masha. *The Man Without a Face: The Unlikely Rise of Vladimir Putin*. London: Penguin Books, 2012. 61-63.
[102] Dawisha, Karen. *Putin's Kleptocracy: Who Owns Russia?* New York: Simon & Schuster, 2015. 40.

its grip on power, and the events of the months leading up to and immediately following the fall of the Berlin Wall seemed to leave an indelible mark on the young Putin.

In October 1989, trains of asylum seekers were allowed to pass through East Germany en route from Prague to West Germany.[103] The cars were locked, but crowds of East Germans in Dresden tried desperately to hop aboard and escape. Such unrest only increased after the Berlin Wall was opened less than one month later on November 7. The ire of the protesters in Dresden quickly turned to the KGB and stasi facilities. A few weeks later, on December 5, Putin was moved by the increasingly aggressive crowd to call upon a Soviet tank unit to come bolster the KGB facility. Putin believed that this would be a small task for comrades with whom he socialized regularly. Instead, they could not provide support because Moscow did not respond to their request for permission to act.[104] Putin's own recollection of this event and the subsequent Soviet withdrawal from Eastern Europe is telling:

> We burned so much [classified material] that the furnace exploded. Moscow was silent… I only regretted that the Soviet Union had lost its place in Europe, although intellectually I understood that a position built on walls… cannot last. But I wanted something different to rise in its place. And nothing different was proposed. That's what hurt. They just dropped everything and went away… We would have avoided a lot of problems if the Soviets had not made such a hasty exit from Eastern Europe.[105]

[103] Bowlby, Chris. "Vladimir Putin's formative German years." BBC News. March 27, 2015. http://www.bbc.com/news/magazine-32066222.
[104] Bowlby, Chris. "Vladimir Putin's formative German years." BBC News. March 27, 2015. http://www.bbc.com/news/magazine-32066222.
[105] Putin, Vladimir et al. *First Person: An Astonishingly Frank Self-Portrait by Russia's President*. New York, NY: Public Affairs, 2000. 79-81.

The futility of the Kremlin to respond effectively to the protests and to protect its KGB officers affected young Putin's view on the fragility of political elites. According to biographer Boris Reitschuster, "Now when you have crowds in Kiev in 2004, in Moscow in 2011 or in Kiev in 2013 and 2014, I think he remembers this time in Dresden, and all these old fears come up inside him."[106] This incident certainly influences the views that Putin and the *siloviki* have on the importance of centralized power and makes them more inclined to exert control over the electorate.

Other characteristics of Vladimir Putin include his desire to return Russia to global prominence, his deep pride in Russian culture and history, and his belief that the West is threatening to both. This worldview is illustrated in the works of three 19th and 20th century Russian philosophers, Nikolai Berdyaev, Vladimir Solovyov, and Ivan Ilyin. Their writings maintain common themes: Russian exceptionalism, Orthodox faith, and autocracy.[107]

The texts describe Russia as the great bridge between Europe and Asia – a place of values, faith, and robust history deserving of a place of power on the global stage. These sentiments come across frequently in Putin's speeches and are clear through his foreign policy calculations and conservative social agenda. The connection of this philosophical framework to Vladimir Putin's agenda is almost eerily apparent in the work of Ivan Ilyin: "we trust and are confident that our hour will come when Russia will rise from

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[106] Bowlby, Chris. "Vladimir Putin's formative German years." BBC News. March 27, 2015. http://www.bbc.com/news/magazine-32066222.
[107] Brooks, David. "Putin Can't Stop." New York Times. March 3, 2014. http://www.nytimes.com/2014/03/04/opinion/brooks-putin-cant-stop.html?_r=0.

disintegration and humiliation and begin an epoch of new development and greatness."[108] Later on, during his third term as President, Putin required that Russia's regional governors read a book by each of these authors over the 2014 holiday season.[109]

In addition to these experiences and writings, Vladimir Putin is also shaped by the like-minded individuals that surround him. Perhaps no member of the *siloviki* shares Putin's views more than Igor Sechin. Sechin was a member of the Leningrad KVS (Foreign Liaison Services) when he first met Vladimir Putin in 1990. The two became friends, and Sechin began working for Putin in 1991. Since then, Sechin and Putin have been close political allies, with Sechin advancing alongside of Putin. When Putin became president, Sechin was made deputy prime minister. The *siloviki* wing of government quickly coalesced around him.[110] In 2004, one cabinet minister reportedly stated, "Sechin is not just Putin's sounding board, Sechin is part of Putin's brain cells."[111] This relationship and Sechin's views on the proper role of the state in the oil sector proved to be important as Putin sought to address energy issues.

The formative years as a young KGB officer, his belief in conservative values and Russian exceptionalism, and the *siloviki* cadre that made up his inner circle all contributed to the formation of the ideology that Putin brought to Moscow when he was elected president in 2000. He sought to reestablish the Kremlin as the true locus of power in Russia and return Russia to a place of prominence in the international community. In

[108] Brooks, David. "Putin Can't Stop." New York Times. March 3, 2014. http://www.nytimes.com/2014/03/04/opinion/brooks-putin-cant-stop.html?_r=0.
[109] Snegovaya, Maria. "How Putin's Worldview May Be Shaping His Response in Crimea." The Washington Post. March 2, 2014.
[110] Dawisha, Karen. *Putin's Kleptocracy: Who Owns Russia?* New York: Simon & Schuster, 2015. 84-85.
[111] Zarakhovich, Yuri. "Inside the Yukos Endgame." Time. August, 22, 2004. http://content.time.com/time/magazine/article/0,9171,685965,00.html.

order to achieve these goals, Putin had to rebuild the recently-collapsed economy and solidify a steady stream of revenue coming into the treasury. With oil production beginning to rebound and oil prices starting to surge, Putin and his allies resolved to begin their reconsolidation of money and power by targeting the oil industry.

Putin Forms an Energy Policy: The Birth of Resource Revanchism

The miraculous turnaround of the brownfield assets of the Russian oil industry offered a lucrative opportunity for Vladimir Putin to reassert control and capture a greater share of the economic rents flowing from the oil sector. While there is some indication that Putin and Sechin were at least marginally open to some economic liberalization in the early 1990s, the corruption and embarrassment they perceived from the loan-for-shares deal, coupled with the economic collapse of 1998, shattered their faith in market reforms. As previously mentioned, the reformers viewed the recession as a result of Russia's inability to fully open up to world markets fast enough. Their solution was thus to double down on liberal reforms. Putin and Sechin fell in the conservative camp that took the opposite view. They believed that embracing Western-style capitalism failed the state and the Russian people.

When Putin took office, he started Russia down the path of a different style of capitalism. While he did not seek to fully renationalize the oil industry, he did seek to reassert heavy state influence over it. There are few sources that help elucidate Putin's thinking on this policy shift, though one of them, a 1999 journal article, is particularly informative. In this paper, Putin emphasizes that the resource sector is the key to national economic growth and that, in the wake of the economic collapse, this sector must be used to fill the treasury so that the state can invest in social and infrastructure projects. He believed that this should be done through public-private partnerships and that the state should help the resource sector, particularly the oil industry, shift its focus higher up on the value chain so that both the state and the industry could move away from pure extractive industry activities and benefit from producing higher value-added goods.[112]

As Putin's first term progressed, concurrently with the increased Western influence at Yukos, his views seemed to shift. Perhaps due to influence from others in the *siloviki* wing of the Kremlin or his more hard-lined confidant, Igor Sechin, Putin came to pursue a more assertive approach in dealing with the oil industry, taking less of an interest in reform and more of an interest in increasing the power of the state. He was not willing to tolerate defiance or obstruction to his plans for rebuilding Russian prestige, certainly not from the industry most critical to achieving his goal.

Finding the Taxes

Putin's quest to rebuild Russia's economic and international prestige through recapturing oil rents started with seeking to solidify the tax base. In the Soviet era, the tax regime was not important. Under the command economy, the state owned all industry. Therefore, if the Kremlin wanted to see greater revenue coming out of the oil industry, it either mandated higher production and sold more oil, or raised the price per unit. Putin did not have the luxury of Soviet-era control over the entire economy, and therefore needed to shore up the tax regime in order to secure the state's revenue stream.

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[112] Goldman, Marshall I. *Petrostate: Putin, Power, and the New Russia*. Oxford: Oxford University Press, 2010. 97-98.

Russia did not solidify its tax regime in the 1990s. Even as late as Putin's election in 2000, the Russian tax system was in shambles.[113] The system was complicated. Companies all throughout the economy took advantage of loopholes and the formal institutions for tax collection were weak at best. The oil companies hid profits from official reports, stored cash abroad in tax havens, and used joint ventures with foreign companies to sidestep paying taxes at home. The regional governments lacked tax collection enforcement mechanisms and often accepted tax payments in kind, in the form of actual oil.

The Kremlin was not much better at maintaining the fidelity of the tax collection system, as its threats toward companies were often arbitrary and empty. In order to make up for a lack of enforcement across the entire economy, Moscow targeted a few of the largest companies. This had the effect of shrinking the effective tax base. As large companies, this strategy put the oil industry under a spotlight, but still did not keep them from avoiding payment. It is estimated that in 1998 oil industry companies were so successful in avoiding taxes that they only paid approximately one-quarter to one-third of their actual revenues.[114]

In order to solidify the state's tax revenue stream, Putin assigned his close confidant, Aleksei Kudrin, as Minister of Finance. Kudrin held this office for eleven years, from 2000 to 2011, making his access to Putin second only to Igor Sechin. With Putin's blessing, Kudrin sought to make several relative straightforward changes to the

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[113] Goldman, Marshall. *Petrostate*. 96-97.
[114] Gustafson, Thane. *Wheel of Fortune: The Battle for Oil and Power in* Russia. Cambridge, Massachusetts: The Belknap Press of Harvard University Press. 2012. 259.

Russian tax regime. By lowering tax rates, broadening the tax base, and closing tax loopholes Kudrin believed he could increase the overall revenue stream coming into the Kremlin. By instituting a more robust collection and enforcement mechanism, Kudrin reduced the ability of firms to avoid payment. Since the majority of companies in the broader economy had relative small tax liabilities and lacked the resources to employ accountants that specialized in finding loopholes, the public reaction to lower rates was largely positive. However, the oil industry understood that the new system meant that they would no longer be able to "optimize" their taxes, thereby representing a threat to their bottom line.[115]

Despite Kudrin's efforts, the oil industry continued to obfuscate its books. He decided to make a radical change. The tax equation for oil companies at the time was two-pronged. First, companies were taxed on exports in order to incentivize the companies to provide low cost oil domestically. Secondly, companies were taxed on profits instead of overall revenue. This system was meant to raise revenue for the state while also being conscientious of the fact that, due to fluctuations in global oil markets, large revenues did not always indicate a successful company with large profit margins. However, taxing profits was difficult because there were many ways for oil companies to game the system in order to hide the actual profit figures and make their margins appear deceptively slim.

Aleksei Kudrin's response was to shift to a single-factor tax rate based on gross revenue. The oil companies were appalled. Under this new tax equation, the government

[115] Gustafson, Thane. *Wheel of Fortune*. 263-264.

paid no mind to the performance of their oilfields, the risks taken by investing in new exploration and production, or the possibility that global market forces would squeeze their profitability. Kudrin and Putin did not care. Putin, in particular, had little sympathy for the oil companies or their owners. He believed that the executives had already robbed the state by being allowed to take ownership of the oil assets. He would not tolerate "tax optimization," even if *technically* legal, viewing it as unpatriotic and unacceptable. The plan worked. The tax revenue received by the Kremlin increased from $5.6 billion in 1999 to $83.2 billion in 2005.[116]

Conclusion

By 2002, Vladimir Putin was reaping the rewards of the miraculous Russian economic turnaround buoyed by rising global oil prices and increased oil sector productivity (the result of Western technology and business practices, no less). He was also profiting from a tax revenue stream from the oil industry that was both markedly greater and more reliable than during the Yeltsin administration. While Putin cannot legitimately claim much more than tangential credit for the economic recovery, the Russian public did not know this. They saw an economy that was revived on his watch. In politics, the leaders with the greatest mandates to govern are those with broad public support. With the economic miracle, Putin and his allies in the *siloviki* wing of the government gained the political capital necessary to push their agenda further. Over the course of his first administration, Putin became more of a conservative statist seeking to consolidate power. As such, his scorn for the reformers and oligarchs grew. No company

[116] Gustafson, Thane. *Wheel of Fortune*. 264.

or oligarch drew his ire and tested his patience more than Yukos and Mikhail Khodorkovsky.

Chapter VI: Putin Takes Action

Yukos in the Crosshairs

By 2002 to 2003, Putin and the *siloviki* began focusing more attention on Yukos and Mikhail Khodorkovsky. While there were certainly other companies within the oil industry employing Western technology and practices, and other oligarchs in various sectors that flaunted their largess, Yukos warranted special attention for several reasons. In addition to the tax optimization methods explained previously, Yukos ran afoul with the Kremlin for using extraction tactics and business practices that were seen as damaging to the physical resources in the ground. Moreover, on an individual level, Putin and the *siloviki* wanted to make an example out of Mikhail Khodorkovsky. In Putin's eyes, Khodorkovsky was the very embodiment of all that was wrong with liberal reforms.[117] He stood for Western ideals such as government accountability. He championed capitalism and loyalty to shareholders over the state. Worst of all, he openly and arrogantly alluded to his political ambitions to replace Putin.

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[117] Goldman, Marshall I. *Petrostate: Putin, Power, and the New Russia*. Oxford: Oxford University Press, 2010. 105-107.

As previously discussed, the Western oilfield development strategies that Yukos used were horrifying to the Soviet-era oil workers that the company employed. Schlumberger and Joe Mach shut in wells, operated dangerously close to the bubble point, and fracked large swaths of land. They viewed the Western practices as a type of scorched earth policy. The *siloviki* and other conservatives in the Kremlin echoed these sentiments. Yukos also ran afoul of the old guard for its techniques because Khodorkovsky and Mach saw profit and asset value as their end game. Therefore, they sought to push production and sales when oil prices were high. They understood the time value of money, the importance of acquiring new assets, and that simply the names on its Board of Directors could affect the value of the company. The Kremlin believed the focus on profit and the practices that followed were detrimental to the resources in the ground, resources still technically owned by the state.

Of all the oligarchs that reaped the rewards of Boris Yeltsin's Faustian loans-for-shares bargain, none reached such heights as Mikhail Khodorkovsky did from 2000 to 2003. In 2001, *Forbes* estimated Khodorkovsky's net worth at $2.4 billion. Just one year later, Khodorkovsky broke with the tacit understanding among oligarchs that the businesses remain secretive. He disclosed the organizational structure of Yukos and revealed, arrogantly, that the company was in fact owned by a small group of business associates that were long suspected of having unsavory ties to the Yeltsin government around the time of the asset sale. It was almost as if Khodorkovsky wished to flaunt his ability to use government influence to amass money and power. And money he had. The same 2002 disclosure also revealed Khodorkovsky's net worth to be approximately $8 billion.[118] Putin was disgusted by the oligarchs' wealth and sense of entitlement. In a 2003 interview with the *New York Times*, Putin explained:

> We [Russia] have a category of people who have become billionaires, as we say, overnight… The state appointed them as billionaires. It simply gave out a huge amount of property, practically for free. They said it themselves, 'I was appointed a billionaire.' Then… they got the impression that the gods themselves slept on their heads, that everything is permitted to them.[119]

Despite the roughshod oilfield development practices; the unsavory tax optimization; and the proud, public opulence; Yukos may still have been largely left alone. After all, Roman Abramovich and his oil company, Sibneft, employed Western techniques. Even Vagit Alekperov and LUKoil engaged in similar strategies, albeit with a cautious eye not to anger the Kremlin. Truly, Vladimir Bogdanov at Surgutneftgaz was the only oil company executive to adhere strictly to Soviet oil doctrine. So what was it about Mikhail Khodorkovsky and Yukos that pitted Vladimir Putin and the *siloviki* so fiercely against them? The most convincing differences were Khodorkovsky's public disrespect for Putin and the state itself, his seemingly independent foreign policy, and threatening forays into politics.

In February 2003, Putin met with the Russian Union of Industrialists and Entrepreneurs. It was essentially a forum for the oligarchs to communicate with the Kremlin. At this meeting, which aired live on Russian television, Mikhail Khodorkovsky made a fateful decision to publicly challenge Putin on issues of government transparency

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[118] Hoffman, David E. *The Oligarchs: Wealth and Power in the New Russia*. New York: Public Affairs, 2001. *491-497*.
[119] Putin, Vladimir. Interview with The New York Times. *The New York Times*. October 5, 2003. http://www.nytimes.com/2003/10/05/international/06PTEXT-CND.html?pagewanted=all.

and corruption, an odd claim coming from someone with a history of shady business dealings. First, Khodorkovsky claimed that corruption was rampant among tax collectors, particularly those dealing with oil, and that the sheer number of applicants for such jobs indicated that it was seen as a path to wealth. Next, he took issue with the recent purchase of Northern Oil by Rosneft. Khodorkovsky stated that the $622.6 million that was paid for the asset was well beyond market value and then wondered how Rosneft, a relatively poor company, could afford to overbid such as they did without help from the Kremlin. He then turned to Vladimir Putin and stated, "Your bureaucracy is made up of bribe-takers and thieves." Putin refused to allow Khodorkovsky's accusations to stand unanswered, particularly in such a public forum. He retorted by questioning the fairness of the deals through which Yukos came to control its most prized assets, stating slyly, "Some companies, including Yukos, have excess reserves. We still have to investigate how they obtained them."[120]

In May 2003, Khodorkovsky pushed his luck even further by signing a deal with the Chinese government to provide 20 to 30 million tons (approximately 140 to 210 million barrels) of oil per year for 20 years. The massive deal hinged on the development of Yukos assets in Eastern Russian and the promise to build a pipeline specifically to serve the deal. By signing a contract with the Chinese government itself, Mikhail Khodorkovsky and the Yukos team were, in effect, implementing their own foreign policy initiatives. Adding insult to injury, not only did Yukos circumvent the Kremlin's authority in the realm of foreign policy, its promise to build a pipeline represented a

[120] Goldman, Marshall I. *Petrostate: Putin, Power, and the New Russia*. Oxford: Oxford University Press, 2010. 113-114.

threat to Transneft's monopoly over the oil pipeline network in Russia. This behavior infuriated Putin and his allies.[121]

In addition to the affronts to the Kremlin's authority over foreign policy, May 2003 also saw the height of Yukos' irreverence for the legislative process. During this time, the Duma, Russia's legislative body, was debating a bill that would shape the legality of production sharing agreements. Given that the legislation was of considerable importance to Yukos, Khodorkovsky called on the cadre of Duma members that he kept on his payroll, counting on them to shape the legislation in Yukos' favor. By some estimates, Khodorkovsky retained upwards of 100 Duma members through bribes.[122] Throughout this particular debate, Vladimir Dubov, the Duma member closest to Yukos, allowed the company's legal team to sit next to him in the chamber as the bill was being marked up. In the most explosive instance, another crooked legislator, Sergei Shtogrin, stood at the front of the assembly to offer amendments to the bill while simultaneously holding a cell phone to his ear and taking orders from the Yukos legal team.[123]

These offenses were very likely more than enough to convince Putin to commence an investigation of Yukos. However, what sealed the fate of Mikhail Khodorkovsky was his venture into politics. It was one thing to cheat the state out of taxes and disrespect the legislative process. It was another thing altogether to threaten Vladimir Putin directly. Khodorkovsky became a spokesman, rather ironically, for increased transparency in governance, Western-style democratic institutions, and civil society. He created a

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[121] Goldman, Marshall. *Petrostate*. 111.
[122] Goldman, Marshall. *Petrostate*. 113.
[123] Gustafson, Thane. *Wheel of Fortune: The Battle for Oil and Power in* Russia. Cambridge, Massachusetts: The Belknap Press of Harvard University Press. 2012. 295.

foundation called Open Russia that sought to foster ties with the United Kingdom and United States and contributed an initial donation of $16 million.[124] He donated tens of millions of dollars to opposition political parties such as Yabloko and the Union of Right Forces.[125] In addition to these indirect political threats, Khodorkovsky threated Putin himself by hinting that he might leave Yukos in 2007 in order to run for president in 2008. This crossed a line that Putin was not willing to ignore.[126]

The Fall of Yukos

In the summer of 2003, Vladimir Putin decided to target Yukos and Khodorkovsky in earnest. He instructed the General Procuracy to open an investigation. The Prosecutor General, Vladimir Ustinov, was a longtime ally of Putin and nominated for his position in part for that very reason. Ustinov coordinated the harassment of Yukos and its officials through raids, tax investigations, and arrests. He even opened investigations against Menatep Bank in an effort to specifically target Mikhail Khodorkovsky.[127]

Sensing that the government was not just seeking to intimidate him, Khodorkovsky made it known that he was in discussions to sell a substantial portion of Yukos to Exxon-Mobil or Chevron. Negotiations that began in 2002 progressed through the summer of 2003 and, in early October 2003, Yukos and Exxon signed a protocol of

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[124] Hoffman, David E. *The Oligarchs: Wealth and Power in the New Russia*. New York: Public Affairs, 2001. 494.
[125] Hoffman, David. *The Oligarchs*. 495.
[126] Goldman, Marshall I. *Petrostate: Putin, Power, and the New Russia*. Oxford: Oxford University Press, 2010. 113.
[127] Gustafson, Thane. *Wheel of Fortune: The Battle for Oil and Power in* Russia. Cambridge, Massachusetts: The Belknap Press of Harvard University Press. 2012. 302-305.

understanding outlining the sale of 40-50 percent of Yukos. Exxon CEO Lee Raymond met with Vladimir Putin twice in September 2003 to discuss the sale and did not believe that the government would object.[128] Hindsight is certainly 20/20, but given what the world now knows about Vladimir Putin's ideology and his views on the importance of strategic state assets, it seems unlikely that he ever had any intention of allowing the sale of 40-50 percent of Russia's largest, most profitable oil company to a foreign firm, an American firm, no less.[129]

After the preliminary agreement between Yukos and Exxon was signed in early October, Putin knew that he had to make his move. Several weeks later, in mid-October, police raided Khodorkovsky's home and a school funded by Yukos, claiming that computers donated to the school had incriminating evidence on their hard drives. Khodorkovsky was not home at the time, but his wife was frightened by the incident. Furious at the affront to his family, Khodorkovsky held a press conference and boldly dared the government to come after him personally, stating, "If the goal is to drive me from the country or put me in jail, they had better put me in jail."[130] On October 25, 2003, Mikhail Khodorkovsky landed at an airfield in the Siberian city of Novosibirsk. A unit of the Russian special police force met him, raided the aircraft, and arrested him on charges of fraud and tax evasion.[131]

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[128] Goldman, Marshall I. *Petrostate: Putin, Power, and the New Russia*. Oxford: Oxford University Press, 2010. 111.
[129] Hedlund, Stefan. *Putin's Energy Agenda: The Contradictions of Russia's Resource Wealth*. Boulder: Lynne Rienner, 2014. 64.
[130] Goldman, Marshall I. *Petrostate: Putin, Power, and the New Russia*. Oxford: Oxford University Press, 2010. 112.
[131] Hoffman, David E. *The Oligarchs: Wealth and Power in the New Russia*. New York: Public Affairs, 2001. 497.

On November 2, Khodorkovsky resigned as CEO of Yukos, but Putin was not satisfied with bringing down Khodorkovsky alone. Russian officials continued their pursuit of Yukos' other executives, mid-level managers, and assets. The government arrested the heads of Yukos' major subsidiaries, claiming that they physically damaged oilfields, reducing their ultimate production potential. The official charge was that the Yukos officials violated the oilfield development plans filed with the state, but it was clear that their real violation was the wholehearted embrace of Western practices deemed to be contrary to Moscow's interests. With Khodorkovsky gone, Yukos was rudderless. With its mid-level managers ousted, it lacked the ability to operate effectively. In June 2004, Yukos' assets were frozen pending investigation.[132]

It is without doubt that Mikhail Khodorkovsky's personal actions and management of Yukos represented, far and away, the most controversial behavior of any oligarch. The catalog of offenses, both those that actually violated statutes and those that simply angered the Kremlin, was staggering: 'destruction' of oilfields, public disrespect toward the government, excessive ties to foreigners, and supporting opposition political parties, to name a few. However, the fall of Yukos represented much more than an assault on one person or one company. The government's actions toward Yukos and Mikhail Khodorkovsky were signals to the oil industry that answered many of the legal questions that pervaded the relationship between the industry and the state since the assets were privatized in 1995. Executives who wondered whether or not questionable tax

[132] Goldman, Marshall I. *Petrostate: Putin, Power, and the New Russia*. Oxford: Oxford University Press, 2010. 116-119.

optimization and controversial oilfield management practices, among other things, were prosecutable offenses got their answer. The effects on the oil industry were monumental.

Foreign Targets

The story of Mikhail Khodorkovsky and Yukos offers a clear example of Vladimir Putin's intentions to roll back the power of the oligarchs and reassert state control over the oil industry. However, it is worth noting that Yukos is far from the only company brought back under state control by the Kremlin's policy of resource revanchism. Indeed, Putin did not only target domestic companies controlled by the brash oligarch class. He also targeted foreign companies that signed deals he felt were unfavorable to the state. One prominent example that is representative of this broader trend is the Kremlin's handling of oil and gas development on Sakhalin Island.

Sakhalin Island is located off of Russia's far east coast, approximately 30 miles north of Japan. The island has a long history of oil production, dating back to an onshore joint venture with Japan in 1928. Russia wanted to develop more substantial production in the 1970s, but put its plans on hold after the start of the war in Afghanistan. After the fall of the Soviet Union, the Kremlin decided to seek foreign partners to help develop Sakhalin's potential and facilitate badly-needed technology transfer. It is likely that Sakhalin did not fall under one of the holding companies established in 1992 due to its extreme geographic isolation and lack of large production wells at the time. As such, the state signed deals with two consortia in the mid-1990s. The Sakhalin I and Sakhalin II projects were to be operated by ExxonMobil and Shell, respectively.[133]

Unfortunately for the Kremlin, its desperation to begin developing Sakhalin's resource potential combined with low oil prices put the state at a disadvantage when negotiating the Sakhalin contracts. As a result, Moscow signed PSAs giving generous tax and cost recovery provisions to the foreign investors. These were exactly the types of contracts that Putin and the *siloviki* felt robbed the state of its rightful resource bounty. Putin knew that the government officials that signed the deals in the mid-1990s did so because they were negotiating from a position of weakness. He was determined to rectify the situation once he had the upper hand.[134]

In 2006, just two years after the state successfully orchestrated the fall of Yukos, Putin took aim at the Sakhalin II agreement signed with Shell. Having recently undergone the early-2000s oil *chudo,* the Russian oil industry and economy in 2006 were much more robust than they were at the time the Shell deal was signed. Oil prices were higher, production was up, and tax revenue flowed more steadily. Conversely, Shell was struggling. The Sakhalin project was significantly behind schedule and budget. This angered the Kremlin because Shell's contract allowed for them to recover cost oil to pay for the capital spent getting the wells online. As such, every dollar over budget spent by Shell getting the wells producing meant that Russia would have to wait longer to see any revenue from the project. Additionally, Shell was being targeted by environmentalists

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[133] Hedlund, Stefan. *Putin's Energy Agenda: The Contradictions of Russia's Resource Wealth*. Boulder: Lynne Rienner, 2014. 48-49.
[134] Hedlund, Stefan. *Putin's Energy Agenda*. 49.

due to its operations on Sakhalin and was threatened with a $50 million lawsuit. Given Shell's weakened position, Putin decided it was time to revisit the contract.[135]

After meeting with Putin, the CEOs from the foreign consortium members agreed to each sell half of their respective shares in the project to Gazprom. This had the practical effect of giving the state 50% plus one share ownership of the project. For their shares, the foreign companies were paid a total of $7.45 billion, far less than what the shares were worth after the time and money that the foreigners put into the project.[136] A Shell spokesman likened the deal to allowing Gazprom to "enter on the ground floor."[137] The foreigners doubtlessly felt as though Russia violated their contract and that after ten years worth of development costs, the Kremlin was unfairly strong-arming them to renegotiate. They were right. The Sakhalin II investors fell victim to the *siloviki* plan to recapture natural resource assets just two years after Yukos met the same fate.

Conclusion

Riding a wave of public support brought about by the economic recovery, Vladimir Putin was soundly reelected in 2004. In his second term, he continued to claw back Russia's oil industry assets from oligarchs and foreign companies, as the 2006 takeover of Sakhalin II demonstrates. Putin and his *siloviki* allies saw an opportunity to push on with the next phase of their plan to further consolidate power over the country and rebuild Russian influence abroad. The assaults on Yukos and Sakhalin II only

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[135] Hedlund, Stefan. *Putin's Energy Agenda*. 70.
[136] Bradshaw, Michael. "A New Age in Pacific Russia: Lessons from the Sakhalin Oil and Gas Projects." *Eurasian Geography and Economics*. 51, Iss. 3 (2010): 352.
[137] Lustgarten, Abrahm. "Shell Shakedown," *CNN Money*, February 1, 2007. http://archive.fortune.com/magazines/fortune/fortune_archive/2007/02/05/8399125/index.htm.

represented the realization of the first phase of Vladimir Putin's policy of resource revanchism. In order to truly wield the power of the massive oil industry both in domestic politics and on the international stage, Putin needed an oil company that he could control more directly, build into a powerful state-owned oil champion, and serve as a conduit for his power and policies. He found the perfect vehicle for his ambitions in a tiny firm, the only holding company that failed to privatize in 1995, Rosneft.

Chapter VII: Building a State Oil Champion

Fending off Gazprom

During the Soviet era, the Kremlin's state oil and gas entity was known as Rosneftgaz, a consolidation of 301 separately operating oil and gas enterprises. After the collapse of the Soviet Union, Rosneftgaz fell victim to the same centrifugal forces experiences by other sectors of the economy. When, as discussed in Chapter I, Boris Yeltsin agreed to create temporary holding companies, the most valuable enterprises sorted into three major entities, LUKoil, Surgutneftgaz, and Yukos. However, those three holding companies collectively absorbed only 42 of the 301 separate Soviet oil enterprises. Rosneft was created as a fourth holding company to house the remaining 259 enterprises. The largest and most profitable enterprises all fell to one of the three major holding companies spun out of Rosneftgaz, but the sheer number of enterprises that were consolidated into the Rosneft holding company meant that it accounted for 60% of Russia's total crude oil production.[138]

[138] Goldman, Marshall I. *Petrostate: Putin, Power, and the New Russia*. Oxford: Oxford University Press, 2010. 62.

When the other three holding companies were privatized in 1995, Rosneft remained publically owned. Due to the fact that Rosneft consisted of a hodge-podge of enterprises, it was not particularly attractive to potential buyers. Rosneft's assets were scattered all over the vast Russian landscape from the Caucasus to West Siberia to the Far East. Its refineries were outdated and required significant capital investment. Aside from oil assets, Rosneft also consisted of the many various components of old government ministries responsible for research. With no need for these functions, potential buyers did not want to be stuck with the responsibility for the tens of thousands of workers these institutes and ministry components employed.[139] The result was a lack of suitors interested in purchasing Rosneft in full.

In late 1998, Sergei Bogdanchikov took over as the head of Rosneft.[140] He was neither a member of the oligarch class or the *neftianiki*. Bogdanchikov was fiercely patriotic and determined to turn Rosneft into a prominent state oil company. Unfortunately, the company he inherited was riddled with debt and in the midst of selling off its prime assets at bargain prices. Case in point, at the time Bogdanchikov took control, Rosneft had just sold its most productive and valuable subsidiary, Purneftgaz, for just $10 million.[141] The Yeltsin administration was never particularly concerned with protecting state assets from a fire sale, but for some reason the sale of Purneftgaz angered the president. Yeltsin instructed the Russian internal security service, the FSB, to

[139] Gustafson, Thane. *Wheel of Fortune: The Battle for Oil and Power in* Russia. Cambridge, Massachusetts: The Belknap Press of Harvard University Press. 2012. 322.
[140] Hedlund, Stefan. *Putin's Energy Agenda: The Contradictions of Russia's Resource Wealth*. Boulder: Lynne Rienner, 2014. 176.
[141] Gustafson, Thane. *Wheel of Fortune: The Battle for Oil and Power in* Russia. Cambridge, Massachusetts: The Belknap Press of Harvard University Press. 2012. 326-328.

investigate and recover the asset. This is an important event not only because Purneftgaz was in fact returned to Rosneft, but because in the process Bogdanchikov met the head of the FSB, Vladimir Putin, and his primary adjutant, Igor Sechin.

When Putin was elected president in 2000, he maintained a strong relationship with Bogdanchikov. After all, both men shared strong statist inclinations and the belief that the oil industry should be used to Russia's benefit, not pillaged by the oligarchs. Putin was not initially convinced that Rosneft was the best vehicle through which to pursue his energy agenda because the company was still quite weak. However, with Purneftgaz back under his control, Bogdanchikov set out to prove Rosneft's worth and consolidate the company's disparate assets. In 2002, Bogdanchikov used the windfall from rising oil prices to buy out those with minority stakes in Rosneft's subsidiaries in order to centralize control of the company under his purview. By strengthening the company's competitive position, Rosneft transformed into a viable state oil champion, and by maintaining relationships with Putin and Sechin, Bogdanchikov started seeing more support from the Kremlin.[142]

The first real sign of state backing for Rosneft came in 2003. Rosneft and LUKoil were both interested in purchasing Northern Oil. Vagit Alekperov, still CEO of LUKoil, was one of the founding members of the consortium that formed Northern Oil in order to explore Timan-Pechora, a vast new oil region situated north of the Volga-Urals and west of West Siberia. Despite his original position, Alekperov and LUKoil were effectively forced out of the consortium, requiring them to bid independently for Northern Oil when

[142] Gustafson, Thane. *Wheel of Fortune*. 332-333.

the remaining partners put it up for sale. Alekperov contemplated litigation but opted against it when he found out Northern Oil was sold to Rosneft. It was clear to Alekperov that Rosneft had the support of Putin. Mikhail Khodorkovsky did not have such tact. Recall that the Northern Oil sale was the instance brought up by Khodorkovsky at the fateful February 2003 meeting between Putin and the oligarchs. When he claimed that Bogdanchikov received unfair support from the state, Putin simply replied that Rosneft needed additional reserves.[143]

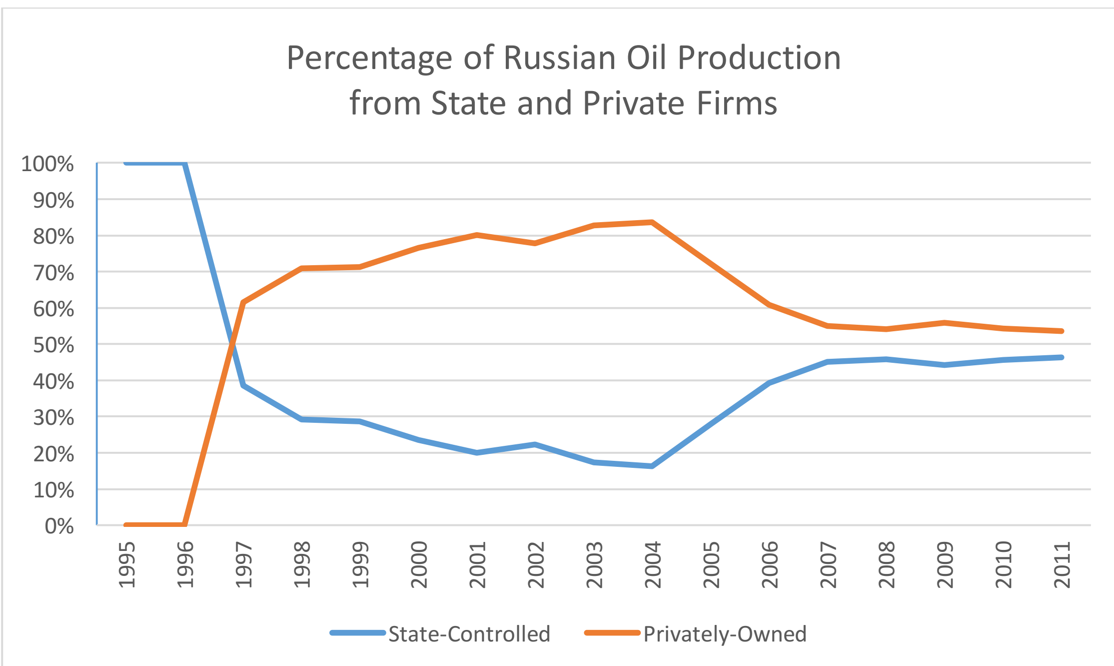
After the arrest of Mikhail Khodorkovsky and the freezing of Yukos' assets, Vladimir Putin began to push in earnest to realize his plan for creating a national energy champion. Based on the increasing support provided to Rosneft, Sergei Bogdanchikov believed that his company would be chosen to carry that banner. However, Putin had grander aspirations. Instead of simply creating a national oil company to complement Gazprom, the state-owned natural gas company that was never privatized after the Soviet collapse, Putin envisaged a singular state energy champion that placed both oil and gas under one company.

Due to a law restricting foreigners from owning more than 20% of Gazprom, its market capitalization was drastically undervalued. Putin wanted to increase the company's value by scrapping the law and allowing additional foreign investment, but not at the risk of losing the government's controlling stake and veto power over decisions. The fear was that as foreign investment poured in, the percentage value of the state's investment would be diluted below 50%, thus costing the Kremlin its control of

[143] Gustafson, Thane. *Wheel of Fortune*. 332-335.

the company. Aleksei Miller, the CEO of Gazprom and a *siloviki* ally of Putin, proposed that the state secure its stake in Gazprom through a share swap of sorts. Miller suggested that the Kremlin sell Rosneft to Gazprom and receive Gazprom shares in return – essentially folding Rosneft into Gazprom as a subsidiary. By adding Gazprom shares equivalent to the value of Rosneft to the shares in the gas company that it already owned, the Kremlin could ensure it maintained its controlling stake even after lifting the foreign investment cap.[144]

Figure 4: Percentage of Russian Oil Production from State and Private Firms



Source: Russian Ministry of Energy found in Gustafson, Thane. *Wheel of Fortune: The Battle for Oil and Power in* Russia. Cambridge, Massachusetts: The Belknap Press of Harvard University Press. 2012. 195.

[144] Gustafson, Thane. *Wheel of Fortune*. 338-339.

Solidifying Supremacy

Putin was initially on board with the plan, but its implementation faltered for several reasons. First, there was hesitance from senior Gazprom executives that were wary of expanding away from their bread and butter, natural gas. Secondly, the plan met opposition from Bogdanchikov and Igor Sechin. The two champions of Rosneft believed that the only way for the company to maintain its independence was to become so large that any effort by Gazprom to absorb it would fundamentally change the make-up of the gas company itself. Conveniently, the assets Sechin and Bogdanchikov sought to purchase were available in the form of old Yukos assets.

In December 2004, the frozen Yukos assets were auctioned off in order to pay back what the Kremlin calculated to be $33 billion in back taxes. Ironically, in the same sort of rigged privatization auction lambasted by Putin and the *siloviki*, the largest prize, Yuganskneftgaz, was sold for $9.35 billion, a pittance, to a suspicious group of investors collectively known as the Baikal Finance Group. Not surprisingly, the Baikal Finance Group turned out to be a shell company for Rosneft.[145] With this one acquisition, Rosneft increased its oil production from 21.6 million tons (154 million barrels) in 2004 to 74.4 million tons (531 million barrels) in 2005, a threefold increase in just one year.[146]

Though Putin initially intended to create a massive, singular state energy firm incorporating Gazprom, Rosneft, and the repatriated pieces of Yukos, he was still pleased with the outcome that allowed all of those assets to fall under state control. After

[145] Goldman, Marshall I. *Petrostate: Putin, Power, and the New Russia*. Oxford: Oxford University Press, 2010. 120.
[146] Hedlund, Stefan. *Putin's Energy Agenda: The Contradictions of Russia's Resource Wealth*. Boulder: Lynne Rienner, 2014. 176.

absorbing Yuganskneftgaz, Sergei Bogdanchikov was replaced as CEO of Rosneft with Igor Sechin. Though Putin and Bogdanchikov remained on good terms, it was clear that only the closest confidants of Putin would be trusted with the management of the two major state energy firms. Under Sechin, Rosneft continued to expand. In 2010, the massive Vankor oilfield in north-central Russia came online, increasing Rosneft's annual production to 115.8 million tons (827 million barrels) of oil.[147]

Today, Rosneft is the largest oil company in Russia, accounting for 40% of oil production in the country. At of the end of 2014, Rosneft claimed to have proved reserves just shy of 34 billion barrels of oil equivalent. Rosneft is the unquestioned crown jewel of the Russian oil industry. With a 70% stake in the company, the government ensures its success. All other oil companies in Russia operate at a disadvantage, as Rosneft is given preferred access to the most promising new discoveries, and all new discoveries above a certain size. Its rise from the ashes of the privatization process of the 1990s, coupled with the fall of Yukos, capped the shocking about face taken by the Russian government in the first decade of the 21st century.

After the collapse of the Soviet Union and subsequent privatization of the Russian oil industry, the Kremlin under Vladimir Putin resolved not just to dispel with the notion that Western business practices and foreign intrusion were acceptable, but also to build a true national oil champion and reestablish the ability of the state to use the oil sector for the national interest. In this regard, Vladimir Putin was quite successful. At the time of

[147] Hedlund, Stefan. *Putin's Energy Agenda*. 176.

his election, state-owned oil companies produced only 16% of Russia's crude oil output. By the time Putin finished his second term, that figure had risen to 50%.[148]

[148] Goldman, Marshall I. *Petrostate: Putin, Power, and the New Russia*. Oxford: Oxford University Press, 2010. 99.

Chapter VIII: Pivot Points and Undercurrents

From the collapse of the Soviet Union in 1991 to the end of Vladimir Putin's first stint in office in 2008, the Russian oil industry experienced a boomerang-like trajectory. It began under total control of the state, with strict, centralized dictates coming from the Kremlin, and industry decisions being made for policy reasons rather than market-based rationale. In 1995, the state threw the ownership of its oil assets out to the private sector. However, many in the Kremlin were never fully comfortable with an independent oil industry. That view is best represented by Vladimir Putin and the *siloviki* wing of Russian politics. With Putin's somewhat coincidental rise to power in 2000, the oil industry, particularly the liberal-minded oligarchs, were forced to contend with a more assertive state. While Putin's relationship with the industry was not entirely confrontational and did include significant collaboration, it is clear that his overarching policy was to reestablish the authority of the state over the oil sector. By the end of Putin's second term in office in 2008, the Kremlin had reestablished either legal ownership or de facto control over the oil industry, completing the boomerang trajectory and returning the oil industry to the hands of the state.

There were several reasons why the independence of the Russian oil industry was so short-lived. First, the privatization process that culminated with the corrupt loans-for-shares scandal in 1995 completely undermined the legitimacy of the newly privatized firms and their owners. Indeed, such a corrupt process even undercut the general public's trust in government by allowing a small, privileged group of businessmen to reap the financial benefits of state assets that had for decades been collectively owned by the Russian people. Additionally, the 1998 financial crisis and sovereign debt default shook the foundation of the Russian economy, providing another incident that precipitated the state's revanchist actions toward the oil sector. In the wake of the recession and the subsequent revitalization of oil production, it was logical that the state wanted to reassert a greater level of control over the industry, making sure to restructure the oil tax regime and help guarantee a steadier revenue stream.

However, while these instances certainly help explain how and why the Russian oil industry fell back under government control, they primarily offer surface-level evidence; factors such as the loan-for-shares scandal and the economic crisis of 1998 were not so critical that they *necessitated* that the state reassert control over the oil industry. Instead, these events, along with the 2000 election of Vladimir Putin, served as important *pivot points* in the history of the Russian oil industry; pivot points that did not cause the renationalization of the oil industry themselves, but did help facilitate the foundational, historical and cultural *undercurrents* explicated throughout this analysis that led to that end. These cultural reasons include the long-standing, formidable history of authoritarian governance in Russia, a centuries-old suspicion of foreign intrusion, and the shame associated with the collapse of the Soviet Union. Each of these core factors were punctuated by the aforementioned pivot points and, ultimately, brought to the forefront of national policy by Vladimir Putin and the *siloviki* wing of the government in the early 2000s.

As discussed earlier, the tradition of strong centralized government in Russia is long-standing. The tsars were the standard bearers of absolute rule, leading the resistance against liberal constitutional reform in the heart of Europe so they would not have to fight it within Russia itself. The Soviet system purported to speak for the masses while it also brutally suppressed dissent. Over centuries of top-down rule dictating national policy and secret police forces hunting down those who spoke out or disobeyed orders, it is little surprise that the broader Russian polity has been infused with an ethos of adherence to the law. Russia is certainly not free of dissent. There is a vocal minority that speaks out in favor of civil liberties and against repressive government tactics. However, the broader predisposition towards obedience is much more abundant. It was seen in the Russian oil industry through the tense relationships between the old guard *neftianiki* and the management of the newly privatized firms, as well as the conflict-ridden interactions between the same firms and the Putin government.

The old guard workers and managers fought to maintain Soviet-era practices. Most of their careers were spent in a time when profit considerations were unnecessary, wells were drilled for the sake of meeting specific government targets, and deviation from the Kremlin's mandates was simply unthinkable. Furthermore, these communities of workers and their families were still engrained with the Soviet mindset that the government would guarantee employment and basic necessities. This fundamental social contract between the Soviet government and its people engendered a willingness in families to endure living in far-flung Siberian oil towns despite the physical difficulties of everyday life. When the newly privatized oil industry uprooted this fundamental understanding by cutting wages and refusing to build schools and hospitals, it created great consternation among both average citizens and traditional-minded government officials alike.

The same history of strong central government control also shaped the relationships that the nascent, private oil industry had with the government. While these companies were ostensibly independent, the Kremlin was never comfortable with an oil industry that was able to make business decisions without its approval. In the 1990s, Moscow used its control over Transneft to maintain veto power over various industry projects and regulate export permits, adding yet another layer of government oversight over the oil industry and restricting business decision-making. Despite the high level of influence that the government maintained in the 1990s, the Kremlin's propensity for control was even greater during the post-2000 tenure of the *siloviki*.

The Putin administration clamped down on oil industry actions that it did not deem beneficial to the state. In order to limit the independence of the industry, the tax regime was overhauled to recapture oil rents. Exploration and production (E&P) contracts that did not pass Kremlin muster were torpedoed. Furthermore, political ambitions and public defiance were anathema to the *siloviki*, as Mikhail Khodorkovsky could attest from his jail cell. In this regard, Russia's limited experience with liberal governance and capitalist business tactics deeply affected both the average oil worker and the political elites in the Kremlin, spurring a reversion to authoritarianism under which the oil industry was returned to state control.

In addition to the history of strong centralized government, Russia's deep suspicion of foreigners also proved to be a critical thread woven throughout the fabric of the oil industry story. From the 13th century Mongol invasions of what was then known as Kievan Rus,' to the Napoleonic Wars of the 19th century, to the fight against Hitler in the 1940s, the threat of foreign invasion has been a part of the collective societal consciousness for about as long as the Russian people have existed as a nation. This suspicion of foreigners extends beyond the perceived threat to territorial integrity. From 1922 to 1991, the Soviet Union distinguished itself from the rest of the world not only by its borders, but also by its unique economic system. The communist order required tight economic control and separation from the rest of the world that was often justified through propaganda promoting cultural and economic exceptionalism. This isolation created another level of mistrust of foreigners that went beyond territorial threats to include fear of foreign economic intrusion and cultural corruption.

Not surprisingly, this cultural characteristic came to the forefront when the oil industry was privatized in the 1990s. The industry fell to the control of oligarchs who disregarded Russian societal norms, placed profits and market capitalization above the needs of the state, and invited foreigners to buy large shares of Russia's oil resources. Such actions provoked vitriol and suspicion from the public and political classes alike. Soviet era oil workers were skeptical of Western business practices and oilfield management, believing that excessive drilling and production rates would damage the health of their reservoirs. Meanwhile, policymakers in the Kremlin balked at the idea of companies like Yukos and LUKoil fully embracing such basic business ideas as the time value of money and tax optimization, considering them unpatriotic, Western cultural intrusions.

Lastly, deep Russian national pride also served as another underlying factor affecting the relationship between the oil industry and the state. While the United States made some gestures of magnanimity after the collapse of the Soviet Union, the Russia of the 1990s was nonetheless humiliated by its new place in the shadow of the United States. The bitterness engendered by American global hegemony in the 1990s was felt most acutely by the *siloviki* class that came to power with Vladimir Putin. As products of the Cold War Soviet security apparatchik, the default lens through which they saw the world was a zero-sum competition with the United States; a competition not just for land or economic supremacy, but for prestige. In this worldview, anything that enhanced the reputation of the West diminished that of the Soviet Union. This mindset increased the suspicion that Western firms faced as they incorporated more efficient business practices into the Russian oil industry. It also explained much of the blame that the West received in the wake of the 1998 financial crisis and certainly contributed to Kremlin efforts to stymie Western investment in the oil industry.

These three cultural factors – long-standing history of authoritarian governance, suspicion of foreign influence, and humiliation in the wake of the Soviet collapse – were less apparent in the 1990s. This is evidenced by Russia's efforts to embrace democracy, convert to a capitalist system, and its willingness to open its economy to Western investment. Yeltsin intended these policy changes to help Russia recover from the Soviet collapse and quickly return to global prominence. Instead of achieving his aims, Yeltsin's administration culminated in the 1998 economic crisis, ushering in the *siloviki* era. With the election of Vladimir Putin, these cultural undercurrents found a champion willing to unabashedly make them part of national policy. As such, Putin prioritized his statist policies over the private sector, stamped out dissent, and sought to reestablish Russia as a geopolitical counterweight to the United States. The resource revanchism exerted over the oil industry was part of this plan. It is therefore not surprising that under Putin the Russian oil industry was the subject of dramatic tax reform, the state used Transneft to influence business decisions, and private companies were strong-armed into relinquishing assets to the state oil and gas champions, Rosneft and Gazprom.

Implications for U.S. Policymakers: The NATO Case

In 2008, Vladimir Putin was barred from running for the presidency again due to Russia's constitutional limit of two consecutive presidential terms. Taking advantage of his high approval ratings, Putin put forth one of his protégés, Dmitri Medvedev, as a candidate to replace him. When Medvedev won the presidency, Putin stepped into the role of Prime Minister, leaving many to believe that he was truly running the government behind the scenes. In 2012, Putin and Medvedev again ran as a pair. However, they swapped roles, allowing Putin to reclaim the presidency. Before leaving office, Medvedev signed a bill extending the presidential term to six years. While this did not affect Medvedev himself, it does mean that Vladimir Putin's current term will last until

2018, at which point he will be eligible to run again in order to stay in power through 2024.[149]

Such political musical chairs do little to veil the true political reality in Russia, that Putin and the *siloviki* continue to consolidate power in the Kremlin and extend influence throughout Russia's various ministries and regional governments. U.S. policymakers would be wise to take note of the fundamental cultural factors that explain the renationalization of the Russian oil industry. They can offer insights into the mindset of Kremlin leadership and Russia's ever-complicated relationship with the West, the most critical aspect being conflict over NATO.

The North Atlantic Treaty Organization (NATO) is the most fundamental part of the United States' relationship with Europe. Policymakers in the United States understand NATO to be a *defensive* alliance that incentivizes military-to-military partnerships, leverages the niche capabilities of smaller countries, and facilitates greater intelligence sharing in a period of growing global turmoil. The success of NATO relies on the sanctity of Article V of the North Atlantic Charter, the obligation of all allies to defend each other because an attack on one ally is tantamount to an attack on all.[150] Inherent in this obligation is the belief that such collective security decreases the overall likelihood of armed conflict. Given the cultural and economic ties that the United States and Europe share, stability and security on the European continent will continue to be of vital

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[149] "On Putin's Terms." *The Economist*. November 14, 2008. http://www.economist.com/node/12622987.
[150] The North Atlantic Treaty Organization. "The North Atlantic Treaty." April 4, 1949. http://www.nato.int/cps/en/natolive/official_texts_17120.htm.

national interest to the United States for the foreseeable future, making the sustainability of NATO critically important.

In early 2016, U.S. Secretary of Defense, Ashton Carter, pinned Russia as the United States' top threat, above terrorism, China, and Iran. One of the reasons for that assessment is the danger that Russia poses to European security.[151] This further underscores the importance of NATO. As U.S. policymakers seek to understand Russia's foreign policy intentions and relationship with NATO, they can glean insights through the same cultural undercurrents that affected the oil industry. Russia's predisposition toward authoritarian rule leads to skepticism about the spread of liberal democratic institutions such as NATO. Russia's fear of foreign influence means that policymakers in the Kremlin are deeply suspicious of all NATO activities. Lastly, Russia's leaders are driven by the desire to undo the humiliation caused by the collapse of the Soviet Union. As such, they regularly try to reassert sway in global affairs by undermining the United States and the NATO alliance.

Despite the West's insistence that NATO is purely defensive, the deep suspicion of foreigners that pervades Russian culture and the *siloviki* currently in government does not allow for NATO to be viewed as anything but a hostile entity that threatens Russian sovereignty and prestige. It is little wonder that Russia condemns each expansion of the Alliance as an affront to their national security. This reaction was understandable when the Baltic states joined, but the Kremlin even voiced its displeasure over Montenegro's

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[151] "The Pentagon's Top Threat? Russia." *The New York Times*. February 3, 2016. http://www.nytimes.com/2016/02/03/opinion/the-pentagons-top-threat-russia.html?_r=0.

ascension to full NATO membership in December 2015 even though NATO presence in the tiny Balkan country can hardly be seen as an existential threat to Moscow.[152]

U.S. policymakers should expect to see Russia continue to test the cohesiveness of the NATO alliance, particularly in the Baltic states, Poland, and Georgia.[153] Due to the fact that the North Atlantic Treaty was signed in 1949 with only conventional military threats in mind, Russia will likely stress the Alliance by engaging in unconventional tactics such as cyber warfare,[154] clandestine paramilitary operations, and violations of sovereign airspace or territorial waters.[155] Such actions pose tangible security threats, but do not clearly trigger the Article V mutual defense clause. The United States should keep in mind how Russian skepticism of foreign influence and post-Cold War embarrassment affect the country's geopolitical strategy. Russia's fear of foreign military, economic, and even cultural intrusion colored their handling of oil industry privatization in the 1990s and 2000s and continues to shape their relationship with NATO to this day. Such important cultural influences on Russian policy should always be in the minds of U.S. policymakers as they consider how Russia might respond to any new U.S. initiatives in Europe and changes in NATO policy.

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[152] Gramer, Robbie. "The New Thorn in Russia's Side." *Foreign Affairs*. December 24, 2015. https://www.foreignaffairs.com/articles/yugoslavia-montenegro/2015-12-24/new-thorn-russias-side.

[153] While Georgia is not a NATO ally, they do maintain close military ties to the Alliance and are a part of the NATO-run Partnership for Peace.

[154] "A cyber-riot." *The Economist*. May 10, 2007. http://www.economist.com/node/9163598.

[155] Dearden, Lizzie. "Full list of incidents involving Russian military and NATO since March 2014." *The Independent*. November 10, 2014. http://www.independent.co.uk/news/world/europe/full-list-of-incidents-involving-russian-military-and-nato-since-march-2014-9851309.html.

Conclusion

The path of the Russian oil industry is often explained through the lens of the loan-for-shares scandal and the 1998 economic crisis, pivot points that were important catalyzing events in the eventual return of the oil sector to state control. However, the more comprehensive approach taken in this study demonstrates the significance of the broader cultural undercurrents that ultimately sealed the industry's fate: the history of authoritarian rule, suspicion of foreign influence, and the desire to rehabilitate Russia's international prestige. The importance and usefulness of such cultural factors is that they offer insights well beyond the oil sector. While the NATO case offers a clear example of where these cultural undercurrents also impact broader Russian relations with the West, it is far from the only aspect of Russia-U.S. relations that they shape. In that vein, the lessons taken from the resource revanchism experienced by the Russian oil industry offer valuable tools to U.S. policymakers seeking to predict decisions made in the Kremlin and understand their impact on an increasingly complex world.

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